

29 Jan 2006

Not for citation- this paper is work in progress and will be completed following the conference. The author would welcome comments in particular on relevant Australian developments.

Australasian Tax Teachers Association Conference 2006

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WHY TAXING THE MICRO-BUSINESS IS NOT SIMPLE- A CAUTIONARY TALE FROM THE 'OLD WORLD'

Introduction to the tale

According to Wikipedia,¹ a **cautionary tale** is told to warn its hearers of a danger. The encyclopedia states that there are three essential parts to a cautionary tale. "First, a taboo or prohibition is stated: some act, location, or thing is said to be dangerous. Then, the narrative itself is told: someone disregarded the warning and performed the forbidden act. Finally, the violator comes to an unpleasant fate, which is frequently related in large and grisly detail." The encyclopedia goes on to cite Lewis Carroll in Alice's Adventures in Wonderland

'Alice had read several nice little histories about children who had got burnt, and eaten up by wild beasts and other unpleasant things, all because they *would* not remember the simple rules their friends had taught them: such as, that a red-hot poker will burn you if you hold it too long; and that if you cut your finger *very* deeply with a knife, it usually bleeds; and she had never forgotten that, if you drink much from a bottle marked "poison," it is almost certain to disagree with you, sooner or later.'

In accordance with this formula, I am going to explain, first the dangers inherent in designing small business policy and second, how the UK government has disregarded the warnings. I shall then relate, although perhaps not in all its grisly detail, what has happened as a result. In expounding this story I shall also refer to other examples of policy makers disregarding dangers. I shall discuss how the unfortunate outcome

¹ <http://en.wikipedia.org>

which has befallen Gordon Brown and his team might be avoided by better behaved policy makers who take more care to listen to advice given. Indeed, to be fair, we shall note how the UK Treasury seems to be beginning to learn from its experience. Finally it will be argued that some radical new thinking may be needed but that it must be consulted on and tested rather than experimenting on the small business sector. Above all, cautionary tales underline the importance of learning from experience and not ignoring the advice of others.

Much of the discussion here is based on UK experiences and UK statistics and care must be taken not to imply that the characteristics of small firms and their problems will be identical in all jurisdictions and, even within jurisdictions, across all sectors. Many of the lessons drawn, however, do seem to be relevant more widely and the debates around tax policy making for small businesses in Australia and the USA seem remarkably similar to those in the UK.

I The warning- dangers inherent in small business tax design

A. The pitfalls outlined

There is tendency to believe that because small businesses do not involve as many people as large businesses and because the sums of money concerned are lower, that their affairs should be simpler. This assumption is mistaken. Micro—businesses may be set up by just one person or they may emerge from acquaintances, friendships, blood relationships and marriage. Since people and their relationships are not simple, micro-businesses, though small, are far from simple organisations. It is unlikely that their tax affairs will be simple either and sometimes attempts to simplify, or to provide relief for small business, can actually create complexity: the concept of **complex deregulation** noted previously by this author in connection with company law.² For example the creation of elections and options for small businesses, intended to assist them, may give them choices that it is expensive for them to consider. Although there may be a resulting tax saving, this might be outweighed by the fees they have to pay to advisers and the time it takes for them to learn about the

² On the phenomenon of *complex deregulation* in company law, see J. Freedman, 'One Size Fits All' *The Journal of Corporate Law Studies* Vol 3 Part I April 2003 123. (Freedman 2003a).

elections and consider them. In a tax context, this concept can be extended to one of **complex simplification**.

This is related to a phenomenon that has been noted in connection with tax simplification by Steven Dean of Brooklyn Law School: that of **attractive complexity**.³ His argument is that relying on taxpayer preferences to guide simplification efforts may produce attempted simplifications that are actually deregulation, but not simplifications at all. The example he gives is that of the check-the box regime in the USA which resulted from taxpayer pressure and may well have been popular as a means of reducing tax burdens but which has not produced tax simplification. Similarly, small business pressure groups might lobby for reliefs but find that they do not ultimately produce simplification, as in the case of the ill fated nil rate of corporation tax in the UK, now repealed. This is the subject of further discussion, below.

This paper will focus on micro-businesses (defined here as businesses with fewer than 10 employees⁴) because the arguments are most marked in relation to them- their profits may be very low indeed and by definition there are few people involved but they are far more complex in the issues they raise than many would predict from those facts.

The main causes of complexity can be classified as follows.

1. The desire to achieve a range of objectives through taxation – not only revenue raising but also micro- and macro economic management. The government objectives of different government departments may conflict and policymaking may not be ‘joined-up’ due to lack of communication.
2. Failure to understand the nature of the micro-business as distinct from the small business, including the failure to recognise the motivations for setting up such a business. Business organisations often represent the larger small businesses for the simple reason that micro-businesses are by definition non-

³ S. Dean, “Attractive Complexity: Tax Deregulation, the Check-the Box Election and the Future of Tax Simplification” *Hofstra Law Review* (forthcoming 2006) <http://ssrn.com/abstract=875004> (Dean 2006).

⁴ An EU definition used by the European Observatory for SMEs: http://europa.eu.int/comm/enterprise/library/lib-entrepreneurship/series_observatory.htm

joiners of organisations. Complexity may be more attractive to larger small firms than to micro-firms because they may have more to gain, but there will be losers as well as winners from such '**attractive complexity**'.⁵

3. The existence of many different legal forms for small businesses which may be adopted by micro-business and the fact that there may be commercial or legal (e.g. employment law) reasons why one of these is preferable to another. There are also family and other personal relationships interacting around the micro-business which may complicate the picture. Government policy is not always joined up.
4. Failure to appreciate the regressivity of compliance costs and to 'think small first'. This may be a more layered problem than is fully appreciated: burdens are not always considered in a joined up way. For example, removal of a tax accounting requirement may not assist, and could even hinder, if the requirement exists anyway for corporation law or commercial reasons.
5. The proliferation of different size thresholds for different purposes. Thresholds may create barriers to growth and increase compliance costs at the borders. Deregulation and reliefs may increase complexity to give **complex deregulation** or **complex simplification**.⁶
6. The inclination to change regimes frequently, often with well-intentioned aims, but failing to appreciate the cost of change. This is coupled with an underestimation of the importance of certainty to the micro business. Certainty is important to the business community generally but even more so to micro-businesses because of the regressive costs of change and learning new systems and rules.

B. The pitfalls in more detail.

Each of these causes of complexity is contentious in some way and so more detailed discussion and justification of the argument that these are 'pitfalls' is required.

1. Diverting from the primary objectives of taxation

Whilst the purist might argue that taxation should be used only for revenue raising it is a fact of life that governments will also wish to use the tax system to manage the

⁵ Dean (2006) above.

⁶ Freedman (2003a) above.

economy at both a macro and a micro level. They seem particularly inclined to attempt to use the tax system to create special incentives and reliefs in the case of small businesses. The two key justifications for this are that there are market failures created by the power of larger firms, asymmetric information, financing difficulties and market barriers and that there are structural costs of being small, such as lack of ability to set off losses against profits elsewhere and generally the regressivity of tax burdens. In addition, the importance placed on small businesses as in terms of the economy and job generation are frequently relied upon to justify tax provisions targeted at small businesses.⁷

Although there may be justifications for special small business tax reliefs, they are not always made clear and sometimes this rationale has not been carefully applied. In addition, even where the rationale is applied, in practice such reliefs are often badly targeted. A further problem is that incentives can often be used by businesses not originally intended to benefit by the legislature. This will then be described as avoidance or even abuse by governments, although arguably it is simply a rational reaction to the structures created by the legislation. Even if the targeted firms are the ones to benefit, this may distort the market in unintended ways by resulting in the allocation of resources to small firms in circumstances where larger firms could use them more efficiently, for example.

A report on best practice by the OECD points out that a tax paid by small business will rarely coincide closely with the target group - that is the tax, be it personal income tax, corporation tax, or general consumption taxes will affect a much wider group. There is no such thing as a small business tax *per se*. Of course this is dealt with often by recreating sub-groups for tax purposes but this creates new thresholds and thus barriers and complexities. As the OECD points out, this lack of precise targeting of tax-based measures must be measured against the attractions of using existing administrative machinery. The report lists the following as areas where the tax system has a potential role: limiting the cost disadvantages faced by small businesses in complying with tax legislation; encouraging the creation of new small

⁷ See OECD, *Taxation and Small Businesses* (Paris: OECD, 1994) discussed further in J. Freedman, 'Small Business Taxation: Policy Issues and the UK' in N. Warren (ed) *Taxing Small Business-Developing Good Tax Policies* Australian Tax Research Foundation Conference Series 23 (2003). (Freedman (2003b)).

businesses; ensuring the continuation of small businesses when control passes from the founder of the firm to another person.⁸

2. *The nature of the micro-business.*

The aim of small business tax reliefs is generally to encourage the growing, rather than the static, small business in order to encourage job creation and economic growth.⁹ The very smallest firms may be start up firms which intend to grow- equally they may be small because they like it that way, known as “life-style” businesses. For many small business owners the motivation to set up their own business is to escape bureaucracy, to balance work and family responsibilities and to obtain autonomy. They are reluctant to grow and in particular, reluctant to take on employees.¹⁰

Reliefs targeted at the very bottom end of the small business sector, whether by number of employees, turnover, profit or some other measure, will catch both these groups indiscriminately and so, for governments wishing to promote growth, will have a deadweight cost. Although there is an increasing volume of research on the characteristics of small businesses and, in the UK, much of this is government sponsored and published by the Small Business Service, there has been a failure in recent years by the Treasury and Inland Revenue to take this information on board when engaged in policy design. There are welcome signs in the latest pre-budget review that this may be improving, in part perhaps as a result of the creation of a new and strengthened tax policy function in the Treasury following a recent review of the UK revenue departments.¹¹ Encouragingly, the announcement by the Australian Board of Taxation that it is undertaking a scoping study of tax compliance costs

⁸ OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices* 22 June 1997.

⁹ See for example HMRC PN01 5 and Partial Regulatory Impact Assessment for Changes to Corporation Tax Structure, December 2005; although other attributes of small business are also recognised by government such as diffusing new ideas and technologies and forming part of the bedrock of local communities and contributing to social cohesions- HM Treasury, “*Small companies, the self-employed and the tax system*” December 2004.

¹⁰ J. Curran, *Bolton 15 Years On: A Review and Analysis of Small Business Research in Britain, 1971-1986*, Small Business Research Trust; E. Walker and A. Brown, “What Success Factors are Important to Small Business Owners?” [2004] 22(6) *International Small Business Journal* 577. (Walker and Brown (2004)).

¹¹ *Financing Britain's Future: Review of the Revenue Departments (O'Donnell Review)* HM Treasury 2004, Cm. 6163. On this review, see C. Wales, ‘The Implications of the O’Donnell Review for the making of Tax Policy in the UK’ [2004] BTR 543.

facing the small business sector states expressly that it will work closely with small business and especially micro business in undertaking the study.¹²

Micro businesses matter. They make up the majority of all businesses in number of enterprises (although not of course in terms of employment or contribution to the economy). In the European Union in 2003,¹³ out of 19,310 thousand enterprises, 17,820 (92%) were micro enterprises under the definition given above.¹⁴ They lagged behind in terms of value added per occupied person but nevertheless employed an average of three people per enterprise, although half of these micro enterprises had no employees at all.

There is a similar picture in the UK statistics. At the start of 2004, there were an estimated 4.3 million business enterprises in the UK and 3.1 million (72.8 %) had no employees at all. About 4 million of these businesses were micro-businesses (93%) and these micro-businesses accounted for around 33% of total employment and 23% of turnover.¹⁵ Although clearly each micro business on its own is less significant and may even be less efficient than any single small, medium or large business, on no measure could micro businesses as a sector be considered unimportant. It is also clear, however, that this sector will include a great variety of businesses with different motivations so that it is necessary to look at the range of types of businesses being dealt with.

Research has shown consistently that only about half of small businesses wish to grow¹⁶ and the larger the small business the more likely it is to want to grow.¹⁷ The UK Small Business Service's Annual Small Business Survey 2004 states that only 11% of small businesses¹⁸ consider themselves to be prevented from growing when they wish to do so. Many of these businesses which do not wish to grow can be

¹² The Board of Taxation, *Small Business Compliance Costs Study Announcement*, 4 November 2005.

¹³ 19 countries at that time (included EFTA countries) .

¹⁴ European Commission *SMEs in Europe 2003*, (2003/7) Observatory of European SMEs , Luxembourg: Office for Official Publications of the European Communities.

¹⁵ National Statistics *SME Statistics UK 2004*, August 2005.

¹⁶ C. Gray "Growth-orientation and the small firm" in K. Caley et al (eds) *Small Enterprise Development*, Paul Chapman Publishing, London 1992; Small Business Service Annual Small Business Survey 2004 (2004 Survey).

¹⁷ 2004 Survey, *ibid*.

¹⁸ Defined in that survey as businesses with zero to 249 employees.

considered life style businesses. The need to make a profit is not irrelevant since obviously few businesses can survive if they do not do so, but many of these businesses also have other measures of satisfaction and criteria for assessing whether their business ventures are successful. Personal satisfaction, pride in the job and a flexible lifestyle may be valued more highly than wealth creation.¹⁹

If tax systems are being designed to create incentives to grow, for example, then it is likely that those incentives will only operate in the way intended in relation to businesses which want to grow in the first place. Other business owners might take the benefits of the incentives without having any intention of growing. The fact that wealth creation is not their only motivation and that they do not wish to grow does not mean that they will not take advantage of any means of cutting the tax cost which is offered to them. This might be argued to be an unintended consequence. Sometimes unintended consequences are inevitable and difficult to avoid, but in this case the consequences of offering tax breaks to all micro businesses is predictable. The breaks will apply to as many firms that do not wish to grow as to those that have a growth orientation.

3. Existence of different legal forms.

The ingenuity of lawyers in devising legal forms for the purpose of doing business has created concepts of major importance without which business as we know it would not operate- notably limited liability. At the same time, this ingenuity creates complexity for the micro business since one of the first decisions that a person setting up in business has to make is what legal form to adopt. Incorporation implies to an economist a separation of capital from labour. The corporate legal form is structured for this purpose but does not require it. Because shareholders, directors and employees may be one and the same people or even one person, the legal form does not necessarily result in such a separation. The UK system of business organisations encourages incorporation by making it cheap and easy. This is an explicit policy of company law reform and the Company Law Reform Bill currently passing through

¹⁹ E. Walker and A. Brown (2004) above.

Parliament.²⁰ In a guide to the new legislation for small business, the government states

“The purpose of company law and corporate governance is to promote enterprise and stimulate investment. We are determined to ensure that our system makes it easy to set up and grow a business”.

Leaving aside whether this is an adequate description of the function of company law, this shows the generally held belief that encouraging incorporation encourages enterprise and growth. It is clearly important not to put barriers in the way of those needing to incorporate but whether incorporation should be encouraged is another matter. Of course a growing enterprise will eventually need some kind of mechanism for organizing its business and procuring limited liability but it does not need to be incorporation. In Australia, business trusts are widely used although they usually use incorporated companies as part of the arrangements; in the US there are more legal forms available, notably the LLC, although the proliferation of legal forms there is beginning to be seen as problematic. In the UK the recently created LLP has been seen by some as a potential vehicle for small firms but that was not the purpose for which it was designed and it is not entirely suitable for this purpose.²¹ Tax transparency of LLPs and the advantages of incorporation in the UK for tax purposes have limited the development of the LLP in the UK for small firms to date.

Incorporation can prove costly eventually and may be a poor idea if the owners do not really understand what they are creating a separate entity. The advantage of limited liability may be illusory as may other supposed advantages of incorporation such as the ability to raise finance more easily where the firm is in fact very small.²² Yet UK government policy is to encourage incorporation for even the smallest businesses- at least that is the policy when it comes to company law. In the case of taxation, as we shall see, incorporation of the very smallest firms may be seen as an abuse in some

²⁰ DTI, “Company Law Reform: Small Business Summary” 2005.

²¹ Judith Freedman “Limited Liability Partnerships in the United Kingdom- Do they have a role, for small firms?” [2001] 26 *The Journal of Corporation Law* 897. For a different view see G. Morse [Title] in ‘*The Governance of Close Corporations and Partnerships*’ (eds. J. McCahery, T. Raaijmakers, E. Vermeulen) OUP 2004 but there has been no rush to use LLPs- 3,321 were registered in 2003-4 and 5,191 in 2004-5- a tiny number compared with new company incorporations (DTI *Companies in 2003 –2004* and *Companies in 2004-2005*, Table E4).

²² J. Freedman “Limited Liability: Large Company Theory and Small Firms” [2000] 63 *MLR* 317.

circumstances- a rather confusing picture for a small business owner and not the stuff of joined up government.

Whilst some research suggests that incorporated businesses are more likely to grow than those which are unincorporated,²³ it does not follow that incorporation is a contributory factor in growth- those who choose to use incorporation may be at a certain stage of the business cycle or may be better advised or more motivated in the first place. Targeting tax reliefs on incorporated as opposed to unincorporated businesses will not result in that relief reaching only businesses that grow or wish to grow. That relief will change behaviour and so change the set of businesses incorporating so that it begins to include more businesses which do not wish to grow.

Neutrality in the tax system as far as choice of legal form is concerned is an obvious desideratum but this is very difficult to achieve because the legal consequences of incorporation have a degree of legal substance which makes companies genuinely different from unincorporated firms in terms of consequences for the parties concerned. Very often the concern is that incorporation increases tax due to the element of double taxation on corporations,²⁴ but in the case of the micro business in the UK the issue is rather different and arises from the fact that ‘business income’, ‘labour income’ and income from capital are separated from each other in what may seem to be an artificial way but which is a natural consequence of the rights and duties created in law.

Short of a complete move away from income as a tax base, which is not the topic of this paper,²⁵ this could be dealt with in various ways. First, income from capital and income from labour could be taxed identically. Unless owner controlled firms can be dealt with differently from others, this is unlikely due to the mobility of capital which is forcing down tax rates on returns from capital globally although the differences could be reduced. Owner controlled companies could be taxed as if they were

²³ D. J Storey *Understanding the Small Business Sector* Routledge 1994 at p140 (note that this is based on research done before incorporation was made more attractive for very small companies by changes in the tax system).

²⁴ See The President’s Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America’s Tax System* November 2005, chapter 5.

²⁵ That is to consumption taxes for individuals and businesses. But it is still necessary to allocate the tax base to different legal persons.

unincorporated²⁶ but attempting to do this would give rise to serious definitional problems. The aim would be to differentiate companies where the owners could adjust the amount paid out by way of salary and that paid as a return of income from those which could not but this is not going to be an easy dividing line. Second, the tax legislation could look through the corporate veil by treating returns on capital as employment income in some circumstances – the difficulty here again is definitional as it is necessary to define those circumstances. This is a problem the UK has encountered as discussed below.²⁷ A third way of achieving some measure of neutrality might be by treating an unincorporated business as if it had some kind of separate entity so that the labour income of such a firm was taxed in a similar way to returns on capital but employment income would continue to be taxed differently. That exchanges one distortion for another and provides an even greater incentive than now to convert employments into self-employment. The President’s Advisory Panel in the USA has recommended a greater separation between business and personal income for unincorporated firms in its Simplified Income Tax Plan but this seems to be largely intended as an administrative measure, and one of doubtful efficacy since it hard to see how the separation would be defined and policed.²⁸

A further reason for the complexity of different legal forms of micro-firms is that they interact with the underlying personal relationships. Thus a business partnership may exist between friends or a married couple. Profit splitting and allocation of interests in capital may occur in a non-commercial way and this will exacerbate the difficulties created by the differences in taxation of labour and capital.

4. Regressivity and removal of burdens.

All businesses complain of complexity but it has been clearly established that administrative burdens, especially those in the area of taxation, are regressive in nature. Compliance costs are regressive, especially where VAT type taxes are involved

²⁶ Tax Faculty of the ICAEW, *Small Companies, The Self-employed and the Tax System* TAXREP 22/05 April 2005.

²⁷ The so-called IR 35 legislation.

²⁸ The President’s Advisory Panel (above). The recommendations consist of a simplified income tax plan and an alternative consumption tax type of plan- the Growth and Investment Tax Plan. The small business implications of these plans are discussed further below.

“The size of the business is a key factor in determining compliance costs, and most of the studies confirm that smaller businesses carry disproportionately higher compliance costs.”²⁹

Governments recognise that the administrative burden of taxation on small businesses is one of the most serious areas of complaint and take seriously the need to reduce such burdens. Both the UK and Australia are currently consulting on compliance costs of small businesses.³⁰ Consideration of burdens as if they were distinct from the substantive law is not, however, likely to help significantly and the starting point needs to be the underlying policy of the law.

This regressivity is the result of diseconomies of scale, the complexity of the tax system and the learning curve necessary for acquiring the knowledge to deal with that system, especially if it changes frequently.³¹ The best way to assist small businesses will be to reduce complexity but as already shown the micro business is a complex animal. The mismatch between legal and economic form, discussed above, is a good example of a layer of convolution which may require *more* complex regulation for the micro business than for the public quoted company. Attempts at providing deregulation or reliefs can result in increased complexity also if they are not properly thought through. The introduction of elective simplified systems which need to be compared with existing systems to assess whether they will produce a saving are an example of this problem.

Apparent simplification that only pushes cost elsewhere can also be a problem. Removal of a reporting requirement, for example, could prove costly if the information no longer stored or the analysis no longer required, is found to be necessary at a later date. In this sense the tax system could have a role in underlining good practice and too much simplification might not be helpful.

²⁹ Chris Evans, ‘ Studying the Studies: An overview of recent research into taxation operating costs’ *eJournal of Tax research* Vol 1 No 1 2003, 64.

³⁰ UK Inland Revenue and HM Customs and Excise, *Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system in small business* March 2005 (IR/C&E 2005); Australian Board of Taxation, *Small Business Compliance Costs Study Announcement*, 4 November 2005. In the UK, KPMG are creating a new tool to model the administrative burden of tax compliance on UK business- R. Anderson,” Red tape: Measure First, Cut Later”, *The Tax Journal*, 23 January 2006, 11.

³¹ C. Coleman and C. Evans “Tax Compliance Issues for Small Business in Australia” in N. Warren (ed) *Taxing Small Business- Developing Good Tax Policies* Australian Tax Research Foundation Conference Series 23 (2003).

Some measure of regressivity is inevitable and compliance costs will always be a problem for the micro-business. It may nevertheless be more efficient for the small business to deal with certain matters of which it has close knowledge that it would be for the revenue services to administer these matters, for example payroll taxes. The market may often come to the rescue here by providing composite services which can be used by the small business sector. But there are instances where the compliance costs are a result of unreasonable off-loading of work by the administration where there is no obvious link between the taxpayer's business and the work to be done. In such instances it will make more sense for the revenue to bear the administration costs. This has now been recognised in the UK by, for example, the removal of administration of the Working Tax Credit from employers to the Government, announced in the 2005 Budget. Despite earlier insistence that it was important for this credit to be clearly linked with work through the pay packet, consultation forced the Treasury to remove this burden from small business after just two years.

5. Proliferation of size thresholds

Unless reliefs are of a kind that can be made available to all, they need to be targeted. It may be that different reliefs will need to be targeted in different ways- it makes sense for a VAT (GST) relief to be related to turnover but an income tax relief to be related to profit. However, this will result in a wide variety of thresholds that will leave the business owner confused and possibly also deterred from growth rather than encouraged, since he may not wish to cross a barrier and face a jump in his tax liability. Coleman and Evans have called for greater definitional consistency where possible as a means of reducing compliance costs.³² The proliferation of tests has been noted as a characteristic of systems in the USA and Australia as well as the UK.³³ Wherever possible thresholds should be harmonised and new thresholds should be considered in the context of existing ones. If there is a need for different thresholds for good reason, the rationale should be clearly considered. In a report prepared for the Institute of Chartered Accountants in Australia, Warren, Payne and Hodgson are

³² C. Coleman and C. Evans, *ibid.*

³³ See the separate contributions of S. Karlinsky and G. Payne to N. Warren *ibid.*

argue that small business definitions should be collected into one piece of legislation so that business and their advisors can view all concessions together and that parliamentary attention should be drawn to deviations in definitions so that such definitions would need a clear justification.³⁴

This would be a useful procedural and administrative improvement but, going beyond these terms of reference and into substance, it could be argued that, if a relief is worth giving, serious thought should be given to whether it could be given across the board to all business to prevent a barrier effect. This will not always be appropriate, but where a relief is unlikely to be one that larger businesses will opt for or benefit from, it may do no harm to make it available generally to prevent a sharp cut off line. A non-tax example is the corporate financial audit. Arguably the limit for requiring a mandatory audit could be set quite high because any serious businesses wishing to borrow or transact major business with will probably to be able to produce an audit report on a voluntary basis anyway. Application of this principle may be more difficult in a tax context but is worth considering in particular instances.

6. Frequency of change and the failure to understand the importance of certainty

All taxpayers desire certainty but it is recognised that there is a trade off between certainty, fairness and responsiveness. Because change is so costly for micro-business due to the learning curve and general regressivity of administrative burdens, successive attempts to improve fairness by fine-tuning may not be appreciated as much as governments expect them to be:

‘Complexity of legislative provisions together with the frequency of legislative change are identified as prime causes of high compliance costs’³⁵

It may be that there are circumstances in which business would prefer to live with a less than perfect provision on the basis that a fairer or more precise provision would be more costly to operate. The costs of change *per se* need to be taken into account in

³⁴ N. Warren, G. Payne, H. Hodgson, *Research and Recommendations on the Definition of Small Business*, January 2006 (ATAX).

³⁵ Evans 2003 citing Sue Green *Compliance Costs and Direct Taxation*, The Institute of Chartered Accountants in England and Wales London 1994.

policy making. The temptation to keep inventing new schemes needs to be avoided. The Chartered Institute of Taxation make this clear in their response³⁶ to the 2005 Consultation by the IR and Customs and Excise (now HMRC) on the administrative burdens of the tax system on small businesses.³⁷ In response to the question, ‘What might enhance the existing range of VAT simplification schemes available to small businesses?’ they state ‘...there are those amongst us who feel that the question posed here is the wrong one. Stability is more important than more simplification schemes and simplification of the system is more beneficial than more schemes to counteract the complexity.’ Here is a direct example of practitioners on the ground resisting what has been called above complex **deregulation** or even **complex simplification**. Previous lobbying has produced a form of Dean’s **attractive complexity** which consists of an array of small business VAT options. Deciding whether to opt for them itself creates cost. For example, the flat rate VAT is used generally only if it will produce a cost lower than using regular VAT accounting, which requires advisers to work the figures for both methods so that there is a compliance cost rather than the intended saving. This comment suggests that these small business advisers at least recognise the downside of adding so-called simplification schemes rather than eliminating choices.

II. Falling into the Traps- some case studies.

Recent experience of small business taxation policy in the UK may be used to illustrate a number of the above points. Whilst some of the damage done has recently also been undone, this undoing as itself been potentially costly since it involves change. Other issues remain in doubt and there is a sense of uncertainty. Generally there is not a good relationship between the small, especially the micro-business sector and government due to the series of measures introduced over the past few years.³⁸ Although the number of small business owners is far smaller than the number of employees, the small business owning taxpayer has strong voice and the

³⁶ CIOT and ATT Response to IR/ C&E (2005) above, June 2005.

³⁷ IR/C&E 2005 above.

³⁸ There is a great volume of literature on the general subject of discontent in the practitioner journals and also on websites. For examples see M. Truman and F. Lagerberg, ‘Am I bovvered? Taxation 8 December 2005; website of Shout 99 at <http://www.shout99.com/contractors/index.pl?n=10>. See also A. Redston, ‘Small Business in the Eye of the Storm’ [2004] BTR 566.

expressions of discontents over their tax treatment has been vocal beyond their number.

A. Corporation tax rates

The prime example of bad policy making for small business in the UK has been the introduction of a zero rate band for incorporated businesses. This illustrates an attempt to stimulate growth through taxation which was not well targeted and which therefore failed. This error also resulted from a failure to understand the way in which legal form of small business worked. There was a failure to differentiate small and micro-businesses. In addition, the attempts to counter the effects of the failure layered a complex so-called anti-avoidance provision over the top of the relief. Even those benefiting from the relief were then involved in cost and complexity. By the time both the relief and the anti-avoidance provisions were abolished last December, the small business community was so pleased to see the back of the complexity that there was no outcry, and generally pleasure, at the disappearance of the relief even though it only brought everyone back to where they were four years previously.³⁹

The changes that have occurred, however, over those four years, had created expenses for businesses which had incorporated and were now not going to benefit as much as they thought they were. There can be tax penalties on disincorporation. The pace of change has left small business owners confused and bemused, especially as they have been berated as tax avoiders, where as far as most of them were concerned they were simply following their accountant's advice to take up an incentive offered to them by Government.

The nil rate was introduced in 2002 and removed in the Pre- Budget Review 2005. There is little or no dissent from the view that this was a failed experiment. The introduction of the nil rate in 2002 was followed by behaviour which all taxpayers and their advisers saw as both rational and entirely predictable but which government

³⁹ Indeed these changes had been proposed by several small business organisations, including the Forum for Private Business, which pointed out that the compliance cost of the anti-avoidance provision outweighed the savings from the nil rate- *The FSB's key recommendations within the pre-Budget report* November 2004. See also A. Southern and J. Meyrick, 'Owner-managed businesses and their tax. An interim report on the views of small businesses' June 2004, Small Business Research Trust, although the results here seem equivocal and possibly those questioned were simply rather confused, or a skewed sample, or both.

preferred to consider as an ‘unforeseen consequence’ and a form of tax avoidance. In other words, businesses incorporated to obtain the tax benefit of the zero rate even if they did not intend to grow. In terms of predictability, this seems to come into the category of red-hot poker burning people. Alice would not have been surprised.

The problem was pointed out by the IFS⁴⁰ and others and highlighted in the Standing committee debates on the 2002 Finance Bill.⁴¹ Nevertheless the government persisted with this policy. Speaking in the House of Commons Standing Committee on introducing the measure, the Paymaster General explained the thinking. ‘The measure recognises that businesses growing beyond a certain size will often be companies. We believe that cutting corporation tax is an effective way of targeting support at small and growing businesses’.⁴²

As discussed above, there is a fallacy in the argument that because the relief was targeted at companies and because companies are more likely to grow than unincorporated firms it would be primarily growing business that were targeted. Although the Treasury had, according to the Paymaster General, taken account of the effects of the new relief on behaviour they do not seem to have understood the flexibility of legal form and the ease with which any business could become a company, whether it wished to grow or not. Thus, the Paymaster General, presumably briefed by her officials, stated

‘Some 78 per cent of businesses are unincorporated despite the fact that there are already theoretical tax benefits for incorporating... There is no shortage of tax advisers seeking to earn a fee from advising companies that that is the best way forward, but we have still not seen that change... We are convinced that the balance is right... Surely small businesses will not look a gift horse in the mouth. We want to create growth and economic activity, and to sustain entrepreneurial activity.’⁴³

⁴⁰ L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, *IFS Budget 2002: Business Taxation Measures* IFS Briefing Note No. 24.

⁴¹ House of Commons Standing Committee F 16 May 2002

⁴² *Ibid* col. 114.

⁴³ *Ibid* col. 115

They soon saw the change and small businesses were not slow to respond to the gift horse. The zero rate were introduced for companies with a profit of £10,000 or less. Beyond that there was a tapering relief for companies with profits up to £50,000 at which point the formula operated to ensure that the entire £50,000 was subject to tax at 19%. The 19% relief remains for companies with profits up to £300,000. For a company with profits between £300,000 and £1.5 million there was (and still is) marginal relief until the full rate of 30% is reached at that level.

Although the £10,000 profit limit was very low it could be achieved in more cases than might be expected through the use of salary payments to family members as well as other deductions. Salaries must be paid ‘wholly and exclusively’ for the purpose of the trade of the company to be deductible⁴⁴ this has not, in the past, frequently been the matter of investigation unless payments are exceptional although this may be changing. Such salaries are, of course, subject to income tax and National Insurance Contributions (social security payments) but if kept low and paid to family members with no other income and so on low or nil rates of tax, savings can be made. Combined with the fact that, following the abolition of advance corporation tax, dividends carry a tax credit even if paid out of profits which have not been taxed, this was an effective and completely legal tax planning route.

Many very small self-employed taxpayers were advised to incorporate and incorporations rose dramatically. There were 222 thousand incorporations in 2001 but 293 thousand in 2002 and nearly 397 thousand in 2003.⁴⁵ The Treasury began to worry. In 2004 it decided that the loss to the exchequer was too great and that action must be taken. The obvious action would have been to abolish the nil rate but this would have involved loss of face. Therefore the Non-Corporate Distribution Rate (NCDR) was introduced.⁴⁶ According to the Regulatory Impact Assessment which was used to introduce it⁴⁷ the measure was necessary to ‘focus tax incentives for business where they are most effective to support enterprise and growth’ and to

⁴⁴ *Copeman v William J Flood & Sons* [1941] 1 KB 202; *Mallalieu v Drummond* [1983] 57 TC 330 (HL)

⁴⁵ DTI, *Companies in 2004-5* Table A4.

⁴⁶ Section 28 and Schedule 3 of the Finance Act 2004 (now section 13 AB and Schedule A2 of the Income and Corporation Taxes Act 1988) noted in S. Ball, [200] BTR 459.

⁴⁷ *Regulatory Impact Assessment Corporation Tax: The Non-Corporate Distribution Rate* 6 April 2004.

'discourage businesses from incorporating solely or mainly for the tax and NIC advantages without changing their economic activity'.

Needless to say the NCDR rate involved long and complex legislation (six dense pages) relative to what was to be achieved. Where distributions were paid out of profits taxed at less than 19 per cent, the NCDR effectively increased the corporation tax rate to 19 per cent on that amount of the distributed profits thus negating the advantage of the nil rate for the vast majority of micro firms which make small profits and need to draw them all to live. In the process, legislation was introduced which was described by one commentator as bordering on the surreal.⁴⁸ Once this kind of legislation is introduced, the legislative mind instantly turns to ways in which it might be avoided and groups of companies might be used, although the amount to be gained would make it hardly worthwhile. Nevertheless legislation is needed since there is an obvious loophole there. The compliance costs created by this legislation and the learning curve for advisers was quite disproportionate but the government response was initially that the tax profession had brought it on itself and its clients by advising the small businesses to incorporate. Not surprisingly in the light of Dawn Primarolo earlier reference to gift horses, the small business community was not impressed.⁴⁹

It is much to the credit of the new team at the Treasury that this rather silly business was cleared up in the 2005 Pre Budget Report proposals by the simple device of removal of both the nil rate and the NCDR. Although obvious, this must have taken some doing with the politicians, but there has been relatively little crowing since everyone is just so relieved. The Regulatory Impact Assessment,⁵⁰ however, has a touch of Yes Minister in its language when it states

'This measure aims to promote growth of small businesses through better targeting of tax incentives and by simplifying the corporation tax structure to minimise compliance costs and allow firms to focus on growing their businesses.'

Gordon Brown, the Chancellor of Exchequer, when announcing this move in his Pre-Budget speech was careful not to repeat the error of suggesting that the small

⁴⁸ Ball, above.

⁴⁹ Examples from the professional press.

⁵⁰ *Partial Regulatory Impact Assessment for Changes to Corporation Tax Structure* 5 December 2005.

businesses incorporating were themselves tax avoiders but instead cast the stone at their advisers, saying

‘I am closing a relief under which, for tax reasons only, people are being persuaded without changing what they do to set up a company...’

This is an extra-ordinary statement from a government which was the one trying to do the persuading and shows a fundamental misunderstanding of what it means to incorporate, given that it is well established that incorporated and unincorporated businesses may have identical underlying economic activities although in a legal sense people do change ‘what they do’ when they set up a company because they alter their rights and duties.

The Regulatory Impact Assessment acknowledges that the change is a response to requests from the small business community to the Treasury’s earlier paper ‘*Small companies, the self-employed and the tax system*’⁵¹ but notes there was no consensus on future developments as a result of the extensive consultation that followed this paper. Thus we are back to square one although the quid pro quo from government for removing the nil rate was to increase first year capital allowances (depreciation) for small businesses for 40 per cent to 50 per cent for investment in plant and machinery made in the year April 2006.

I have dwelt on this example because it is hard to find another that is quite so clear a cautionary tale against ignoring good, common sense advice. Do not ignore the significance of legal form or think that incentives can easily be targeted. Companies are no different from unincorporated firms in this unless they wanted to grow in the first place when the company law and commercial advantages (such as the availability of floating charges as a form of finance) may assist them to grow. People will react to tax incentives by changing their behaviour. Most small businesses are micro businesses and most micro businesses are not in the business of growing. Bolstering indiscriminate reliefs with provisions to cut them down creates complexity in the tax system for all and this increases cost and resentment of the tax system.

⁵¹ See n [9] above.

B. Status issues

The problem of defining self-employment and distinguishing it from employment will be familiar to Australian readers. In the UK, unlike Australia,⁵² the distinction continues to be governed by the old case law.⁵³ The incentives to be self-employed are in part tax based as a result of more relaxed rules on deducting expense for the self-employed but the real driver is social security (National Insurance Contributions) where there are significant savings to be made through self-employment.

1. Personal Service Companies

Many micro-businesses provide services rather than goods and they may be hard to distinguish from employees on the traditional tests. Those to whom they provide their services do not wish to engage in difficult question of whether they are employees- for tax, employment law and other legal reasons⁵³ they wish them to be clearly providing only services. As a result they encourage or even require these businesses to incorporate. The person supplying the services is still an employee, of course, but he is an employee of his own company: a personal service company (PSC). This opens up opportunities for extracting at least part of the remuneration for the services by way of dividend and so saving NICs. Income splitting with other family members also becomes possible.

The difficulty here is that whilst some of these PSC owners are merely disguised employees, some genuinely may be budding entrepreneurs, given the chance, but both types often start off by working only for one client and have some of the common law badges of employment. The Government has seen the development of personal service companies (which existed well before the nil rate complication described above but was not helped by it) as a form of tax avoidance. From April 2000, special rules for taxing PSCs were imposed.

Once again this seems to reveal a lack of understanding of the way businesses form and develop. Of course some of these PSCs are nothing but employees seeking to pay

⁵² New Business Tax System (Alienation of Personal Services Income Act) 2000.

⁵³ For a fuller discussion of these issues see Freedman, *Employed or Self-employed? Tax Classification of Workers and the Changing Labour Market* (IFS, 2001).

less tax but this legal form may encourage even those who start out as essentially employees to start thinking and acting like real entrepreneurs. In any event, the avoidance, if there is such, is not initiated by the workers but by the often-larger businesses being serviced in this way. In its original form, this legislation would have imposed a duty on these to whom services were being provided, which might have had a positive social effect in persuading such businesses to revert to straightforward employment, but the superior lobbying power of the businesses soon ensured that responsibility was transferred to the workers. This legislation then made less sense than originally intended but the government ploughed on with it. Having introduced it they may have thought that the nil rate for small corporations could safely be introduced because all non-entrepreneurial small businesses would be caught by the PSC legislation. This also shows a misunderstanding since not all non-growing, micro-businesses have the characteristic that they are disguised employees. The rich pattern of different micro-business types was not recognised.

The rules designed to tax personal service companies known as IR 35 after the number of the press release heralding their introduction, have been met with much discontent and litigation.⁵⁴ There was a problem of inequity as between employees and disguised employees to be countered but the wide way in which this has been done and the disregard for employment law issues has led to resentment and may mean that workers pay tax as employees but without any of the non-tax benefits. In addition some genuine entrepreneurial activity may be deterred.

The legislation⁵⁵ subjects the earnings of personal service companies and other entities (such as partnerships) to income tax and NICs, as if the individual had earned them. The rules apply where a worker provides his services to a client who is a business (not, for example, to householders); the arrangements are made through an intermediary such as a company or partnership and the worker would have been treated as employee of client for tax and NICs purposes, had the arrangement been made between the worker and the client.

⁵⁴ See *R (on application of Professional Contractors Group Ltd) v IRC* [2001] STC 629. *The Professional Contractors Group* is now funding the test case of *Jones v Garnett* [2005] EWCA Civ 1553 (CA) discussed further below – see their web site at http://www.pcg.org.uk/cms/index.php?option=com_content&task=view&id=1044&Itemid=150

⁵⁵ Introduced by Finance Act 2000: now Income Tax (Earnings and Pensions) Act 2003 Part 2 Chapter 8. Noted J. Freedman, 'Personal Service Companies- "the wrong kind of enterprise"' [2001] BTR 1.

Where these rules apply, the client continues to pay the intermediary gross and salary paid by the intermediary to the worker is subject to the normal PAYE and NICs rules in the normal way. But to the extent that the intermediary does not pay out its entire earnings as salary, the intermediary is treated as paying a salary to the worker on the last day of the tax year (or earlier, if relationship with intermediary ceases before then). In addition, benefits in kind paid to the intermediary are taxed in the same way as employee benefits. Dividend tax relief is given to prevent double taxation, and a deduction is allowed for expenses of running intermediary equal to 5% of the receipts from the engagements caught by the legislation. Any amounts spent by the intermediary, which could have been claimed as expenses against income tax had the worker been employed by the client and had paid them himself, can be deducted but only under the more restrictive employee deduction rules.

In determining whether the worker would have been an employee of the client had there been a direct relationship between them, the existing case law that seeks to distinguish the employed from the self-employed is used. This case law is fact-based and lacking in clarity, leaving workers and intermediaries in a state of uncertainty.

The IR 35 legislation falls into a number of the pitfalls described above. It makes no attempt to understand the real motivation of the people using PSCs and also fails to relate the use of the corporate form with action in other areas of the law such as employment law. It is complex and uncertain in its operation which imposes a cost and burden on more people than it is seen as a threat by far more business owners than are actually affected and is a source of a great deal of work for professional advisers. These advisers should not be let off the hook since they have been happy to encourage incorporation for tax reasons and are also active in creating concern about IR35 in quarters where there is no need to worry about it, but then none of this is surprising or unreasonable. An adviser who had not advised a client to consider incorporation when the nil rate was available would have been negligent.

2. *Income splitting*

A feature of PSCs noted above is that they facilitate income splitting. The IR35 legislation prevents this, but where the legislation is not applicable income splitting remains possible. In Australia, likewise, there is a problem perceived by the ATO where the alienation of personal services income legislation does not apply but in Australia it seems that this may be tackled under the General Anti-avoidance Rules, although possibly there has been a recent retrenchment on this approach following the decision in *Ryan v Commissioner of Taxation*.⁵⁶ In the UK, since we have no GAAR, HMRC has resorted to using anti-avoidance provisions designed for settlements and categorically not originally intended for this situation.⁵⁷ This has proved an expensive and confusing experience and the litigation continues in a test case, *Jones v Garnett*, also known by the name of the company as *Arctic Systems*.⁵⁸ A detailed discussion of the specific legal provisions analysed in this case is outside the scope of this paper but much has been written and will be written in future and it raises fundamental issues of principle relating to the micro business.⁵⁹

Briefly, and in a much simplified form, the story is a familiar one. Mr Jones was an IT employee made redundant in 1992. He and his wife started an IT consultancy. IT agencies would only deal with limited companies so that they and their clients were not bothered with tax and employment law issues, so Mr and Mrs Jones acquired a off the shelf company and purchased one of the two issued shares each at £1 each. Mr Jones was the company director. Mrs Jones not a director but was company secretary and handled the administration.

Over 4 years, Arctic provided Mr Jones services to 3 agencies and 4 clients, one client at a time. He was working full time for the company but Mrs Jones spent only 4-5

⁵⁶ ATO Taxfacts, 'General anti-avoidance rules and how they may apply to a personal services business' March 2003; ATO 'Refocus of income-splitting test-case programme 13 December 2005; TD 2005 129.

⁵⁷ Formerly section 660A ICTA 1988 and now in Chapter 5 of Part 5 to Income Tax (Trading and Other Income) Act 2005.

⁵⁸ *Jones v Garnett* [2005] EWCA Civ 1553 (CA).

⁵⁹ See M. Robson, 'Jones v Garnett: settlements and all that', [2005] BTR 15; G. Loutzenhiser, 'Jones v Garnett: High Court gives taxpayer the cold shoulder' [2005] BTR 401; HMRC, 'A Guide to the Settlements Legislation for Small Business Advisers' (HMRC Guidance)

http://www.hmrc.gov.uk/practitioners/guide_sba.pdf; Guidance note from professional bodies on self-assessment following Court of Appeal decision in *Jones v Garnett*, January 2006
http://www.icaew.co.uk/viewer/index.cfm?AUB=TB2I_90449

hours per week on company business. There was some question of IR 35 applying but the level of activities was just enough to prevent this. Clearly, in a world without tax and employment law there would have been no need for a company. However, that is not the world we live in and there was a genuine company for perfectly rational and legal reasons. These reasons included tax reasons but fiscal motivation alone does not invalidate a transaction for tax purposes.⁶⁰ The Jones knew they were setting up a structure that might result in a tax saving but also, in effect, we can say that Mrs Jones was investing in Mr Jones, just as if the company had owned a painting or a piece of land she would have invested in that.

The turnover of the company was £91,000 and salaries were kept low: Mr Jones was paid only £7,000 pa and Mrs Jones £4,000 pa. This was the area of attack. Mr Jones was clearly being paid less than market value for his work and this allowed profits to be taxed at low company rate and stripped out in the form of dividends with a tax credit and no national insurance to Mr and Mrs Jones who could then both use personal allowances and lower rate tax bands.

This was an example of completely standard tax planning, although the salary to Mr Jones was on the low side, but he and others were very surprised to find themselves under attack for current and past years as a result of HMRC claiming that the settlements provisions in Part XV of ICTA 1988 applied. The Special Commissioners (court of first instance), found in favour of HMRC as did Mr Justice Park in the High Court. The Court of Appeal overturned the lower courts and found in favour of the taxpayer. HMRC are currently seeking leave to appeal to the House of Lords. In essence the issue was whether there was a settlement. This involved deciding whether there was any element of bounty, a judicial gloss put on the meaning of settlement and discussed extensively in the case law.⁶¹ The statutory definition describes a settlement as an arrangement and much depended on what was included in the arrangement here. The Court of Appeal decided that the arrangement here was the acquisition of a share for which both parties paid full value in the context of a joint business venture to which both would contribute. The governance arrangements under which Mr Jones

⁶⁰ *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51, [2005] STC 1.

⁶¹ *Chinn v Hochstrasser* [1982] AC 533; *IRC v Plummer* [1980] AC 896; *Copeman v Coleman* (1939) 22 TC 594; *Crossland v Hawkins* (1960) 39 TC 493; *Mills v Commissioners of Inland Revenue* (1974) 49 TC 367

but not Mrs Jones was a director were also included but this did not necessarily confer a benefit on Mrs Jones. There was no ‘bounty’ in this set up. Subsequent dividend payments were not part of the initial arrangement. The company would not necessarily make any profit. It would not necessarily pay dividends. It was all unpredictable. As Lord Justice Keene commented, ‘It is difficult to regard such a Protean state of affairs as capable of being part of an arrangement in the sense used in the legislation.’

He went on to state that the purpose of the legislation was not clearly ascertainable and in those circumstances the Revenue’s position seemed to be to argue for an unwarranted extension.

‘For the first time, they seek to apply the concept to what has been found to be a normal commercial transaction between two adults, to which each is making a substantial commercial contribution, albeit not of the same economic value. Such a difference, by itself, is not enough to my mind to take the arrangements into the realm of ‘bounty’, as it has been understood in the existing cases. If the legislature wishes such an arrangement to be brought within a special regime for tax purposes, clearer language is necessary to achieve it.’⁶²

While it is clear to see the mischief being attacked here, the use of the settlements provisions is widely thought to be misconceived. It is a lazy approach to policy making because the problem is perceived as being too hard to tackle with new legislation. This has created serious uncertainty for many small businesses and a general sense of persecution. The purpose of referring to the case in this paper is to highlight this policy failure rather than to investigate the fine detail of the settlements provisions, although there is an important story to write on this also.

The central feature creating this problem is the ability of micro-businesses to incorporate and thus transform income from labour into income from capital. Within a family context but where the regime is one of independent taxation of spouses, there are many conflicts of policy and practicalities. This is a question that needs addressing as a matter of policy in a holistic way, looking at the rules on family taxation, small

⁶² Other detailed issues arising in the case and not discussed here were whether, if there was a settlement, there was an applicable exception for an outright gift which was not substantially a right to income. This could become important in the House of Lords if it is decided there is a settlement but the comments here were obiter. The legislation as drafted is obscure with a complex legislative history.

business taxation and capital transfers between spouses in the round. Instead of this, the government has simply allowed HMRC to continue to address the issue as a self-contained operational matter. They have attacked a form of doing business which has a long pedigree with anti-avoidance legislation designed for another purpose in the 1930s. It is arguable that the case affects fewer businesses than is being implied by the professional bodies, who argue it could affect 200,000 family businesses. HMRC argue that only 30,000 businesses are at risk and this may be because they may pursue this only in what they consider to be extreme cases (although the case of the Jones hardly seems that extreme).⁶³ This is not a sufficient safeguard, however. Small company owners cannot know whether they are at risk since, even after the test case is decided, each case will be decided on its facts. They are required to self-assess and subject to penalties if they get this wrong. The HMRC guidance runs to 50 pages, with detailed examples, but cautions that there may be circumstances in which the interpretation it gives will not apply because cases turn on their own facts.⁶⁴ In effect, the rule HMRC really want to apply is that set out in their summary at 6.2 of that document.

“When considering whether or not the settlements legislation applies it is worth remembering that Parliament introduced the settlements legislation to prevent individuals transferring their income to a relative or friend in order to avoid tax. It therefore follows that a simple test to indicate whether or not the legislation might apply is to consider whether the same arrangements would have been made with a third party at arms length. Take a step back and consider, “If I was making these arrangements with an independent third party would I be paying them these wages or dividends or sharing my partnership profits in this way? If the answer is no then the legislation probably applies.”

This looks very like a GAAR. The UK does not have a GAAR and the Court of Appeal has not applied the above test but, rather, one based on the wording of the legislation HMRC sought to apply. On the facts of the Arctic case, the settlements legislation did not have the effect HMRC are arguing for. But small business owners have little guidance on which to base their self-assessment tax returns due in at the

⁶³ Figures are taken from the High Court hearing – see Loutzenhiser, above.

⁶⁴ HMRC Guidance, above.

end of January, although the professional bodies have done what they can to assist.⁶⁵ The result is complexity and uncertainty and a sense that the government is antagonistic to small business which is precisely the contrary of what government policy set out to be.

It is interesting to note how similar a position seems to have been reached in Australia by the very different route of the GAAR. In its Taxfacts note the ATO comments that

‘others may disagree with these views and that concepts of employment, business and entrepreneurship have progressed since the cases from which our views were formed were heard. We are looking to identify test cases to obtain further judicial guidance as to the correctness of our views. We are doing so in consultation with tax professional bodies.’⁶⁶

Now they have lost the case of Ryan they continue to argue that Part IV A may apply in blatant cases but maybe not standard husband and wife partnership cases, although in a case where the remuneration of the main service provider was very low, as in Jones, it is not clear what their views are.

In neither jurisdiction does this seem to be a good way to create or implement policy for small family businesses. It fails to understand the nature of such businesses and the contribution made by them as well as the importance of tax stability. In the UK, it asks the courts to answer impossible questions about the value of a spouse’s contribution to the business because the tax system has permitted income from employment to be converted into income from capital. If a person in Mr Jones’s position is to be taxed on a minimum deemed salary then this needs to be made clear and the circumstances in which it is to happen must be spelt out. In trying to formulate these circumstances the policy makers would encounter grave difficulties as there is a lack of clarity of objective. They should not expect the courts to be able to solve this problem for them. The current approach falls predictably and firmly into the pitfalls for those making small business policy.

⁶⁵ Fn 59 above.

⁶⁶ N above

III The moral of the story and living happily ever after.

As with all cautionary tales, it is easier to deliver dire warnings than to prescribe a course of action, other than staying at home and avoiding all excitement. Perhaps that is the lesson here for governments. The best thing may still be to interfere as little as possible, to keep change limited and to move away from introducing a lot of special schemes which require definition, thresholds and anti-avoidance provisions. Keeping it simple may mean just that- doing nothing.

The tax system for small businesses will only be as good as the system for business generally and, given the drawbacks with profits taxes and the problems of integrating corporate level and shareholder taxes we cannot expect an easy answer for small businesses. The latest major report on tax reform, the US President's advisory panel proposals,⁶⁷ offers one radical proposal for all firms, the Growth and Investment tax plan, which is a quasi-consumption tax, or a less radical simplified income tax plan. The latter would offer cash basis accounting for business under \$1 million annual cash receipts. Small businesses could expense all outlays and would have no other special measures, for example no research and development credit. SMEs, incorporated or not, would use designated bank accounts for all business income and expenditure. The report is a little short on practical detail here but it seems that the bank would report direct to IRS and business would be prohibited from making personal expenditures out of this account. It will be interesting to see discussion of these proposals which seem to understand small business very little and the significance of legal form in terms of real legal consequences even less.⁶⁸

There may be administrative changes that can be made to ease the lot of small business in connection with their tax burden but for the most part they want clarity and stability and not a great selection of schemes which advisers may like to advise them about (attractive complexity) but which they would sooner not have to worry about even if the result was a little more tax. The time of the business owner may be worth more than the tax saving resulting from such schemes. If certain behaviour is seen as undesirable, then revenue authorities need to spell out the circumstances

⁶⁷ December 2005

⁶⁸ Shaviro, Tax Notes December 2005 questions the practicalities.

clearly, for small business owners will take advice from tax advisers on tax minimisation quite reasonably and should not have to make fine distinctions dependent on case law to ascertain whether what they are doing will be effective. Governments must remember that the small business owner, even if very close to being disguised employees, are legally not employees and do not have their advantages. The small business owner may well see himself as running a small business, encouraged by the rhetoric of governments themselves, and if he takes risks that his clients will not bear, why is he not performing one of the functions of a genuine small business and why should he not be able to take the tax advantages the system offers such risk takers?

The message to tax policy makers, therefore, is to examine small businesses, especially micro-businesses in their social and family context. Understand what drives them and understand that they are not simple. They have many motivations and targeting tax reliefs on a whole range of businesses in this way will affect behaviour across the range and not only to enhance entrepreneurship and growth. Do not confuse cause and effect- incorporated businesses may be more likely than unincorporated ones to grow but it does not follow that all incorporated firms wish to grow, especially if there are tax advantages to incorporation without growing.

At the same time, recognise that legal form really does make a difference to rights and obligations and therefore to economic substance so that encouraging incorporation should not be done lightly. It is not a popular message but perhaps incorporation should be made harder and not easier-the easy availability of such a form for the small business is not a simplification and perhaps is an attractive complexity.

Finally, in attacking supposed mischief, policy makers must be clear about the perceived mischief and its underlying causes. If the cause is a distortion in the tax systems, do not blame the small business for utilising the distortion. Micro-business owners are not always rational but nor are they entirely irrational. To return to the cautionary tale, if business owners are offered sweets, they will take them, but if they find they are laced with poison they may learn eventually not to take any more sweets. Sweets need to be handed out with care, to the people who will benefit from them, and they should not contain poison.