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COMPANY LAWYER BRIEFING

The OTS Small Business Tax Review: a positive start to simplify the UK tax system

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Introduction

On July 20, 2010, the Office of Tax Simplification (OTS) was set up by the Chancellor and the Exchequer Secretary, marking the beginning of a challenging mission—the simplification of the UK tax system.¹

A key issue on the OTS agenda is how to reduce the complexity of small business taxation. About 95 per cent of UK businesses are small, i.e. with fewer than 10 employees, and this type of business is disproportionately exposed to the complexity of the tax system. The first interim report of the *Small Business Tax Review* (the interim report) was published by the OTS on March 10, 2011.²

In the interim report, the OTS identified the dual system of income tax and National Insurance as key source of complexity in small business taxation. The personal service company legislation (IR35) exemplifies the complexity and distortion within the current system. Radical reforms to integrate these two systems and abolish the personal service company legislation were proposed by the OTS. However, their suggestions were rejected by the Government, although the go-ahead was given for research into some more minor changes.

Based on the issues raised in the interim report, this piece will look at the current system of income tax and National Insurance in order to show the underlying

problems within the system, and emphasise the necessity of a long-term reform put forward by the OTS. Integrating income tax and National Insurance would be the optimal plan although the obstacle of bringing this about is significant. The inconsistent areas, on which the reform should focus, have been highlighted. This piece also draws lessons from two alternative proposals to reform the existing tax system in the short term in order to reduce the imbalance between taxpayers in different employment status. However, temporary plan will only resolve the problems partially and may bring unexpected influence to the system. The fundamental structural reform upheld in the interim report should be carried out and on.

Suggestions from the OTS

In the interim report, suggestions for reform focused on the following three areas³:

1. Areas for structural reform:
 - integrating income tax and national insurance contributions (NICs), including the employment and self-employment boundary; and
 - creating a radical new approach to taxation for the smallest unincorporated businesses.
2. Other areas that could be reformed on a shorter timescale:
 - improving elements of HMRC administration including more efficient collection of Class 2 NIC and simplified monthly payroll;
 - choice of legal form;
 - reimbursable expenses and benefits for employees;
 - improvements to the capital allowances regime; and
 - consideration of a simple VAT system for small businesses which trade internationally.
3. Amendments or alternatives to the existing IR35 legislation:
 - suspend IR35 with the intention of permanent abolition, using the period of suspension to investigate behaviours and costs;
 - keep IR35 legislation unchanged, but improve the way it is administered by HMRC; or
 - introduce a new business test to exclude a large proportion of the population currently affected by IR35 from the legislation.

* The author wishes to thank Anne Redston for her helpful and valuable comments on early drafts.

¹ Details are available at <http://hm-treasury.gov.uk/ots.htm> [Accessed December 11, 2012].

² Office of Tax Simplification, *Small Business Tax Review* (March 2011), http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

³ Office of Tax Simplification, *Small Business Tax Review* (March 2011), p.11, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

Among the above three categories, the first recommendation (the integration of income tax and NICs) and the third recommendation (reform of IR35) are mainly addressing the same problem, namely the inconsistent tax and National Insurance treatment between the employed and self-employed, as the IR35 rule is a specific anti-avoidance legislation governing personal service companies, which are innovated to take advantage of the disparate tax and National Insurance charges on different employment status. As stated in the report, “reducing the differential between the income tax and NIC rates and treatments for different income streams and legal forms would reduce this incentive and simplify the system for taxpayers, their advisers and HMRC”.⁴ The question of how the differential income tax and National Insurance treatment complicating the existing system needs to be addressed.

Analysis of the existing system—identifying the problems

Freedman and Chamberlain have summarised the different tax and National Insurance treatment of the employed and self-employed in four aspects: collection mechanisms and timing; the income tax base; National Insurance contributions; and benefits and VAT.⁵ After more than a decade, and despite the abolition of the Schedule system on which the UK tax system had been based, similar problems associated with income tax and NICs, as pointed out by Freedman and Chamberlain remain.

It is emphasised in the interim report that by integrating tax and National Insurance, the issues existing within the context of employment status (dividend v salary, IR35 legislation, benefits, and income v capital) would be much reduced.⁶ The problems existing within the above six aspects will be reflected in the following discussion. In the next section, the different tax and National Insurance charges between employed and self-employed will be presented in terms of collection mechanisms, expenses deductibility and different National Insurance classes to show the imbalance. In addition, further tax advantages derived from operating through incorporation will be analysed which underlines the incentive of taxpayers trading through personal service companies.

Different collection mechanisms and expenses deductibility for income taxation between employed and self-employed

In 2011–12, income tax is estimated to raise £158 billion for the UK Government.⁷ About 90 per cent of total income tax per annum comprises taxes on earnings from an office or employment. Sole traders and partners are also subject to the same income taxes, which are calculated according to different bands of income and personal allowances.

The distinctive feature of collecting income taxes from employment is through a system called Pay as You Earn (PAYE), which is a deduction-at-source system. This means before employers pay their employees, due taxes have to be deducted from the money and paid to tax authorities. There is no mechanism for a self-employed person to “pay as he earns” in the way the employed do. A self-employed person is taxed on the annual profits arising or accruing from his trade or profession under the income tax rules and on any gains under the capital gains rules. Most self-employed workers have to calculate their profits and pay taxes on an instalment basis. They will pay 50 per cent of their estimated tax liabilities in January of the tax year, followed by a further 50 per cent in the following July, with any balance due in the next January. Compared with the self-employed, employees, whose income taxes are deducted every week or month, suffer a cash-flow disadvantage.⁸

When calculating taxable income, a huge difference between employment and self-employment is the deductibility of expenses: the rule on deductibility of expenses for employees is much more restrictive than that for the self-employed. The test of deducting expenses for employees requires the expense is “wholly, exclusively and necessarily incurred in the performance of the duties of the employment”,⁹ while for the self-employed, “no deduction is allowed for expenses not incurred wholly and exclusively for the purposes of the trade”.¹⁰ The deductibility rules for the self-employed are more flexible, and they can use their own judgment as to what and how to incur expenditure.¹¹ Objectively, as pointed out by Freedman, the PAYE system cannot cope with what would otherwise be huge numbers of adjustments for personal circumstances.¹² The associated administrative costs and technical difficulties are significant barriers.

⁴ Office of Tax Simplification, *Small Business Tax Review* (March 2011), p.13, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

⁵ Judith Freedman and Emma Chamberlain, “Horizontal Equity and the Taxation of Employed and Self-Employed Workers” (1997) 18 *Fiscal Studies* 87, 90.

⁶ Office of Tax Simplification, *Small Business Tax Review* (March 2011), pp.14–15, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

⁷ *Budget 2011*, p.6, <http://www.hm-treasury.gov.uk/2011budget.htm> [Accessed December 11, 2012].

⁸ Freedman and Chamberlain, “Horizontal Equity and the Taxation of Employed and Self-Employed Workers” (1997) 18 *Fiscal Studies* 87, 91.

⁹ ITEPA s.338, formerly ICTA s.98.

¹⁰ ITTOIA s.34.

¹¹ Freedman and Chamberlain, “Horizontal Equity and the Taxation of Employed and Self-Employed Workers” (1997) 18 *Fiscal Studies* 87, 88.

¹² Freedman and Chamberlain, “Horizontal Equity and the Taxation of Employed and Self-Employed Workers” (1997) 18 *Fiscal Studies* 87, 89.

Significant gap in National Insurance charges between employment and self-employment

Despite the difference of deductibility of expenses, the employed and self-employed are levied under the same income tax rules. However, the dramatic disparity between the employed and self-employed is brought about by different National Insurance charges. In 2011–12, government receipts from National Insurance were £101 billion, the second-largest revenue source after income tax.¹³

National Insurance is alleged to be distinguishable from income tax because it was invented initially to support the “contributory principle” that benefits received should reflect contributions paid. Originally, employees paid “employee NICs” while their employers paid “employer NICs” in return for the individual receiving entitlement to various flat-rate benefits when the employee was unemployed, ill or retired, in accordance with the contributory principle.¹⁴ This system is still there, but in a vestigial form.

The change started when NICs became earnings-related in 1961, and, NICs and income tax began to move closer together. NICs are collected under different categories. Classes 1, 1A and 1B relate to employment income. Class 1 NICs are paid by both employees and employers; Class 1A NICs are now payable on most benefits in kind and are paid by the employer not the employee¹⁵ and Class 1B is only paid by employers. Classes 2 and 4 relate to profits from self-employment. Class 3 is a voluntary contribution.

Class 1 contributions, comprising the greater part of total NICs receipts, have two categories: primary contributions from employees and secondary contributions from employers. NICs are subject to different rates within progressive bands. In 2011–12, employee contributors paid nil on earnings below £139 per week (£7,225 per year); 12 per cent on earnings between £139 and £817 per week (£42,475 per year), and 2 per cent on earnings over £817 per week.¹⁶ If the employee is contracted out of the State Second Pension, a reduced rate of 10.4 per cent will apply.¹⁷ Employers pay secondary Class 1 NICs at 13.80 per cent on their employees’ earnings above £136 per week (£7,072 per year). See <http://www.hmrc.gov.uk/paye/rates-thresholds.htm> [Accessed December 11, 2012].

In comparison, the regime for the self-employed is much more generous. The self-employed pay two different classes of NICs: Class 2 and Class 4. Class 2 contributions are levied at a flat rate (£2.50 per week for 2011–12) when earnings or profits exceed the small

earnings exception, currently £ 5,315 per year. Class 4 contributions are paid at 9 per cent on any profits between the lower profits limit (£7,225 per year for 2011–12) and the upper profits limit (£42,475 per year for 2011–12), and at 2 per cent on profits above the upper profits limit.¹⁸ The contribution of the self-employed is usually far less than the aggregation of contributions paid by the employee and employer.

In spite of the significant National Insurance payment, benefits in return cannot justify the contributory principle, as Redston points out that “employment represents an insurance policy which is deployed when something goes wrong”, because most benefits of employment do not apply until the employee is facing risk of losing his job (dismissal, illness, retirement, over-manning etc).¹⁹

The more the Government takes from employees, the more workers will seek to bring themselves within the more fiscal attractive self-employed regime.²⁰ Furthermore, combining the advantageous corporation taxes, self-employed people conduct their business through companies, which has led to the prevalence of personal service companies in the United Kingdom since the 1990s. Lower corporation tax and further payment reduction through “income splitting” are the two principal advantages derived from personal service companies.

More advantages granted by the corporation form—lower corporation taxes

The tax advantages of working as self-employed have been enhanced by operating through a personal service company. Because all corporate profits are taxed as capital income, despite being a hybrid of labour income and capital income especially for owner-managed companies, incorporation provides the opportunity of converting income from labour to income from capital, which is called “income shifting”.²¹ “The labour income earned by corporate owner-managers is taxed at a much lower rate than labour income earned outside the corporate sector.”²²

A significant feature of UK corporation tax is the division between the main corporation tax rate and small company/profits rate. In 2011, the full corporate tax rate was 26 per cent, reducing to 25 per cent in 2012, and the small profits rate was 20 per cent. On average, the corporation tax rate was lower than the income tax rate. The threshold for higher rate income tax (40 per cent) was £35,000, while £300,000 was the cap on the small profits rate, and the full rate started at £1,500,000. Profits

¹³ Budget 2011, p.6, <http://www.hm-treasury.gov.uk/2011budget.htm> [Accessed December 11, 2012].

¹⁴ Stuart Adam and Glen Loutzenhiser, “Integrating Income Tax and National Insurance: An Interim Report”, IFS Working Papers No. WP21/07 (2007).

¹⁵ See <http://www.hmrc.gov.uk/nic/class1a.htm> [Accessed December 11, 2012].

¹⁶ See <http://www.hmrc.gov.uk/ni/intro/basics.htm> [Accessed December 11, 2012].

¹⁷ See <http://www.hmrc.gov.uk/ni/reducedrate/contractedout.htm> [Accessed December 11, 2012].

¹⁸ See <http://www.hmrc.gov.uk/ni/intro/basics.htm> [Accessed December 11, 2012].

¹⁹ Anne Redston, “Small Business in the Eye of the Storm” (2004) 5 *British Tax Review* 566, 567.

²⁰ Natalie Lee, *Revenue Law Principles and Practice*, 27th edn (Bloomsbury Professional, 2009), p.148.

²¹ A distinction from the use of “income shifting” here and the way in which the phrase was used in the UK in the aftermath of the *Arctic Systems* case, *Jones v Garnett* [2007] UKHL 35; [2007] 1 W.L.R. 2030.

²² Peter Birch Sørensen, “Neutral Taxation of Shareholder Income” (2005) 12 *International Tax and Public Finance* 777.

between £300,000 and £1,500,000 benefited from a tapering marginal relief from the full rate of corporation tax.

A “corporation”, compared with an unincorporated business, offers the flexibility of proportioning profit distribution between salaries and dividends. Directors can decide the best combination of profit distribution to reimburse their shareholders (who would be employees in an employment context). Further, as dividends are not subject to National Insurance, to the extent that true salaries are paid as dividends, National Insurance may be avoided.²³ A common combination is paying a salary equal to the personal allowance and taking the balance in dividends. This allows variable payment of corporate income to individuals who run their work activity through a corporate entity, with resulting advantages of lower income tax and National Insurance.

Further advantages granted by the corporation form—income splitting

Besides the tax advantages obtained by the worker himself who operates via a company, there are further tax advantages. “Income splitting” or “income shifting”, according to HMRC, is another important advantage available to incorporated business. Within a corporation, shareholding is divided between the owner and his family members, while in reality the main service supplier is the owner and others only do secondary or no work for the company, which can reduce the overall taxes by making use of family members’ personal allowances and lower rate bands.²⁴ Nevertheless, the nominal remuneration paid for labour services does not match the economic value actually earned by that person.

The Government has, unsuccessfully, attempted to introduce new anti-avoidance measures. The HMRC approach was to try to tax the family company as a settlement, and assess distributions to other family members as the settlor’s income in some circumstances (the settlor in these cases being the family member supplying most of the work),²⁵ but there are operational difficulties in determining the varying degree of labour/capital contribution depending on particular circumstances.²⁶

Personal service companies and IR35

The significant differences in tax treatment between employed and self-employed workers make the use of personal service companies popular with both employees and employers. Many clients even prefer workers to provide services through an intermediary company, as

this can reduce the burden of operating PAYE and employer’s National Insurance and almost no risk of employment law claims. The IR35 rule is closely related to the issue of income tax and National Insurance and therefore has been reviewed together in the interim report.

From the Government’s perspective, personal service companies are seen to undermine social order and fairness. This was part of the rationale for a piece of highly contentious anti-avoidance legislation, which has ever since been known by its press release number: IR35. As stated in that April 1999 press release, workers operating through personal service companies:

“[M]ay have no right to sick pay or maternity leave. They may even lose their jobs without entitlement to notice or redundancy pay. They will usually have no right to any claim for unfair dismissal and may lose their entitlement or social security benefits through a failure to make adequate contributions.”²⁷

The personal service company legislation, still commonly known as IR35, came into force in April 2000. The original provisions were in Sch. 12 Finance Act 2000 (FA 2000), which were rewritten and now included in Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) Pt 2 Ch.8.

IR35 aims to capture these engagements of “disguised employees”, under which an individual provides his services directly to his client, and would be an employee of his client if there were no personal service intermediary company.²⁸ If only there were a clear division between the status of being employed or self-employed, the implementation of the IR35 rule would be straightforward and non-controversial. However, there is no clear-cut division between employed and self-employed. This is also a key point the interim report has discusses. The OTS believes clarifying the employment and self-employment boundary is crucial to the integration of income tax and National Insurance, and to reduce the manipulation of incorporation.²⁹

As Redston points out, there are no clear definitions of employment or self-employment; “instead, the tests derive from numerous employment, tax and negligence cases, and are thus subject to adjustment as new decisions emerge from the courts”,³⁰ leading to a lack of certainty. Because of no consistent determination of employment and self-employment, income tax and National Insurance that falls due will be charged from the deemed employment without entitlement to the employment benefits for those caught by IR35.

Subsequently, after the introduction of IR35, a new kind of managed service company emerged to get around IR35. These new companies provided a packaged service:

²³ However, there is a trade-off, because salaries paid by companies are deductible from taxable profits, while dividends, as a distribution of profits, are not.

²⁴ Claire Crawford and Judith Freedman, *Small Business Taxation* (Institute for Fiscal Studies, Oxford University Press, 2008).

²⁵ Crawford and Freedman, *Small Business Taxation* (2008), p.21.

²⁶ Anne Redston, “Income Sharing: The Nelsonian Option” (2007) 6 *British Tax Review* 680.

²⁷ Budget Press Release, March 9, 1999 [1999] STI 469.

²⁸ FA 2000 s.60 and Sch.12.

²⁹ Office of Tax Simplification, *Small Business Tax Review* (March 2011), p.19, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

³⁰ Anne Redston, “Keep it, change it, bin it?” (2009) 164 *Taxation* 438.

calculating salary, National Insurance, PAYE, profits, corporation tax and dividends, and liaising with agencies or clients. People working through managed service companies could also reduce their income tax and NICs by taking their money in the form of dividends and expenses. The growth of this kind of company caused a significant loss of revenue to the Government, as they were unable to police these companies using the IR35 rules. New provisions have been introduced to make sure those working through managed service companies are taxed as employees.³¹

Although the existence of IR35 is a deterrent for individuals to incorporate, the use of personal service companies is still prevalent. In the interim report of the OTS, the scale of the problem was shown through some general statistics³²:

“HMRC data from forms P35 in 2007/08 and 2008/09, show that 70,000–75,000 declare themselves as service companies annually. Of these, 30,000 applied IR35 or the Managed Service Company legislation in 2007/08, while in 2008/09 this number had dropped to 9,500.”

Before the implementation of IR35, tax authorities envisaged the revenue yield should be £900 million annually; however, only £9.2 million had been raised in the five years from 2002/3, which was less than £2 million a year.³³ Regarding the effect of implementing the rules in light of the high cost, high stress and low revenue, the abolition of IR35 has long been proposed.³⁴

Because of the diversity of work patterns, it is difficult to draw a universally applicable employment definition. Ironically, a clearer concept for tax purposes usually makes circumvention of the rule easier. Small businesses are within the grey area where the employment status may be ambiguous. These cases should be decided according to specific facts and circumstances: the principle of substance over form is always applicable. For the Government, they need to unify the inconsistent treatment of employed and self-employed within a different law context to avoid the situation where taxpayers are treated as employed for tax purposes and not entitled to employment benefits under the employment law.

Proposed reform

After showing the inconsistency of tax and National Insurance treatment between the employed and self-employed and the manipulation of incorporation for tax advantages, the author strongly supports the proposals

in the OTS interim report: the merger of income tax and National Insurance and subsequently the abolition of the personal service company legislation. The whole tax system would be more transparent and simplified as a result. Eventually, a simplified tax system will bring about a win-win situation to both taxpayers and tax authorities. In the following section, the benefit of the structural reform by making income tax and National Insurance treatment consistent between the employed and self-employed will be stressed. Two alternative plans different from those in the interim report will be considered before the complete integration of income tax and National Insurance, including popularising limited liability partnership and learning lessons from Norway’s tax reform.

Long-term structural reform—alignment of income tax and National Insurance

The lack of direct link between contributions and benefits makes National Insurance similar to a tax. In the interim report, the potential significant simplification that would be brought about by the integration of income tax and National Insurance is highlighted. Possible difficulties during the integration process are also mentioned, but it is believed that, in the long run, fundamental simplification in this area could be achieved.³⁵

In the interim report, some of the differing areas of the existing two systems are listed, which are the factors complicate the tax system and have to be sorted out before any alignment plan can occur. These factors include work to achieve consistency in the definition of earnings, consistency in the required calculations, reliefs and exemptions in both income tax and NICs, and in the treatment of pensions, self-employment, savings and dividend income. In the Government’s response to the report, reforms to unify the differences between the two systems have been promised.³⁶ Research conducted by the Institute for Fiscal Studies (IFS) points out there are at least two significant potential advantages of integration: administrative efficiency and transparency.³⁷

Administrative efficiency

It is extremely burdensome for employers to deal with the two systems separately, especially for smaller businesses, which are less able to afford experts to deal with their tax affairs. Further complication is brought about by operating the cumulative PAYE system. Differences in calculation of income tax and National Insurance put considerable burden on employers:

³¹ ITEPA 2003 Ch.9 Pt 2 (ss.61A–61J) and s.688A, Income Tax (Pay As You Earn) Regulations 2003 and ITTOIA 2005 s.164A.

³² Office of Tax Simplification, *Small Business Tax Review* (March 2011), p.43, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

³³ Redston, “Keep it, change it, bin it?” (2009) 164 *Taxation* 438.

³⁴ Redston, “Keep it, change it, bin it?” (2009) 164 *Taxation* 438.

³⁵ Office of Tax Simplification, *Small Business Tax Review* (March 2011), p.9, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

³⁶ David Gauke MP responded on behalf of the Government to the OTS interim report; details can be found at <http://www.hm-treasury.gov.uk/ots.htm> [Accessed December 11, 2012].

³⁷ Adam and Loutzenhiser, “Integrating Income Tax and National Insurance”, IFS Working Papers No. WP21/07 (2007).

“It also estimated the compliance burden for employers of operating income tax and NICs at £759 million p.a., and an additional £300 million for HMRC in collecting national insurance.”³⁸

Transparency

The integration of both systems could release employers from high levels of administrative burden. What is more, the transparency of the UK tax system could be greatly improved. Politicians are currently under limited pressure to increase income tax rates. Instead, they raise the rate of National Insurance. The Government’s view is that income tax and NICs should remain separate: the essential justification given by the Government is to maintain the contributory principle and to protect contributory benefits entitlement through NICs.³⁹ In reality, the relationship between government funding for public benefits and NICs is not that close.

For instance, as indicated by IFS, the contributions allocated to the NHS only make up a small part of NHS funding⁴⁰:

“A set of very complicated rules determine which parts of which classes of contributions are notionally allocated to the NHS; but this constitutes only a small part of NHS funding, and if the Government wishes to increase NHS spending it can do so from general taxation. Contributory benefits are notionally financed from the NI Fund, but in years where the Fund was not sufficient to finance benefits, the Fund was topped up from general taxation revenues, and in years (as now) when contributions substantially exceed outlays, the Fund builds up a surplus, largely invested in gilts: the Government is simply lending itself money.”

Although the alignment of income tax and National Insurance could be an ideal improvement to the current UK tax system, this will inevitably increase the headline rate of tax, which seems politically impossible in the near future and has already been left aside at the moment. Even if the two systems cannot be integrated completely,⁴¹ policy-makers should remove unnecessary differences to refine the system to improve the administrative efficiency and transparency.

Temporary/short term plan—substitution for IR35

Three temporary alternative options are suggested by the OTS to reform the existing policy of IR35 under the broad integration plan:

- (1) suspend IR35 to find out the practical effects of doing so;
- (2) improve HMRC’s administration of the existing IR35 rules; and
- (3) invent a “genuine business test to exempt certain businesses from IR35 entirely”.

⁴² The Government’s response to the report only agreed on the second plan to improve HMRC’s administration, while the other two recommendations were refused, because it is argued that IR35 remains an effective deterrent and to devise a new test is too challenging.⁴³

As the reform plans of IR35 proposed by the OTS have been refused by the Government, in the following, two different alternative plans are put forward to tackle in the short term the type of incorporation that IR35 addresses in order to show that the effect of implementing IR35 can be achieved in a different and better way. The first proposal of popularising the use of limited liability partnerships can make the IR35 rule redundant without integrating the income tax and National Insurance. The second suggestion of learning lessons from the Norway’s reform of its tax system not only provides an example for the UK Government to follow, but also indicates the problems within the current UK taxes indirectly.

Popularising limited liability partnerships

There would surely be protests against the abolition of the small profits rate, for it would be argued that genuine small businesses want to make use of the limited liability protection provided by incorporation, rather than using it purely to seek tax advantages. As a matter of fact, the need for limited liability protection could be addressed in another way, through the use of limited liability partnerships (LLPs). A LLP could act as a filter to distinguish incorporation for commercial need and IR35 type of company.

An LLP, a hybrid of partnership and company, is a vehicle inheriting most advantages of those two vehicles—it “combines the organisational flexibility and tax status of a partnership with limited liability for its members”.⁴⁴

³⁸ Office of Tax Simplification, *Small Business Tax Review* (March 2011), p.16, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

³⁹ David Gauke MP responded on behalf of the Government to the OTS interim report; details can be found at <http://www.hm-treasury.gov.uk/ots.htm> [Accessed December 11, 2012].

⁴⁰ Adam and Loutzenhiser, “Integrating Income Tax and National Insurance”, IFS Working Papers No.WP21/07 (2007), p.21.

⁴¹ One of the problems of abolishing NICs is that UK is a party to international social security agreements. It is not a purely domestic issue, but would require international negotiation.

⁴² Office of Tax Simplification, *Small Business Tax Review* (March 2011), p.42, http://hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf [Accessed December 11, 2012].

⁴³ David Gauke MP responded on behalf of the Government to the OTS interim report; details can be found at <http://www.hm-treasury.gov.uk/ots.htm> [Accessed December 11, 2012].

⁴⁴ Explanatory Notes to the Limited Liability Partnership Act 2000.

An LLP is taxed in the same way as a general partnership, which is tax transparent. Individual members of an LLP are subject to the same classes of National Insurance as partners (i.e. self-employed). There are no employers' contributions, which would be payable in a company situation. The availability of LLPs may offer a new path towards solving the issue of tax-motivated incorporation.

Richard Murphy identifies the legal form of the limited company as a fundamental obstacle to resolve the problems in the field of small business taxation. He claims the company rules were devised in circumstances which are no longer the case for many small companies today.⁴⁵ When the rules on incorporation were introduced they made an important assumption about companies: separation between ownership and control of the company, which is not true of most small businesses now, whose ownership and control are unified. This can lead to a disparity of tax treatment of similar economic activities: the corporation tax which incorporated small businesses are subject to confers on them extra advantages compared with the unincorporated.

LLPs could possibly overcome the difficulties that government has with incorporated small businesses in terms of income splitting, but could still reserve other advantages of incorporation for the businesses themselves. Separate legal personality, limited liability, tax transparency, fewer administrative burdens and credibility are all available in one entity. Crucially, LLPs cannot pay dividends, which reduces the chance of income splitting and prevents conversion from highly taxed labour income into less highly taxed corporate income. What is more, unlike companies, LLPs cannot retain profits in the entity which would otherwise be sheltered from income tax.

Taxation exerts a significant influence on choice of legal forms in the United Kingdom. Murphy's perspective is to advocate a different legal form to overcome the existing confusion, which has much to recommend it. However, as he suggests, besides the transition of legal form, the tax rates also need further consideration.

Though substituting LLP for the existing corporation form can align the treatment within the self-employment region, it does not touch the problem of different tax and National Insurance rules for the employed and self-employed. Furthermore, it is worried the implementation of LLP for self-employment would be avoided by trading through EU-registered companies.

Lessons from the Norwegian dual income tax system

Norway has a broadly similar tax system to the United Kingdom: dual income tax and the imputation system for dividends. Although there are many differences in detail, the boldness and rationale behind the Norwegian reform is worth further examination.

First stage—income splitting for active owners In Norway, there was a distinctive group labelled "active owners", who were business owners as well as working in the firm as managers, perhaps even taking part in primary production activities. For the owners of sole proprietorships, partnerships and companies to qualify as active owners, they must meet two criteria: they must own at least two-thirds of the firm, and contribute certain amount of time working in the firm.⁴⁶ This group resembles the owner-managed small business in the United Kingdom.

In order to deal with income shifting problems, profits from firms with active owners were mandatorily split. An imputed rate was used to calculate capital income with the residual amount classified as labour income. The imputed rate of return on capital was identified "as the interest rate on five year government bonds plus a risk premium of four percent"⁴⁷:

"The rationale for the imputed return is that it may be interpreted as the return that could be obtained elsewhere and is in this sense an opportunity cost of capital. In other words it is the return that would be required in order to invest in a particular business in the absence of taxes."⁴⁸

The splitting approach attempted to reflect with the economic essence of profits earned by active owners. However, the active owner test can be easily avoided by spreading shareholding and controlling working hours, as actually happened in Norway. From 1992 to 2000, the ratio of businesses subject to the splitting rule had declined from 55 per cent to 32 per cent.⁴⁹

Second stage—shareholder income tax Subsequently, the Norwegian tax reform committee proposed a new "shareholder income tax" to solve the problem of income shifting. The shareholder income tax is "a personal tax on the equity premium, i.e. a personal tax on returns to shares in excess of the after-tax interest rate on government bonds".⁵⁰ To counteract avoidance of the mandatory income splitting by active owners, corporate equity income above the normal after-tax return on savings will be taxed at a total marginal rate which is roughly in line with the top marginal tax rate on labour

⁴⁵ Richard Murphy, "Small Company Taxation in the UK: A review in the aftermath of the 'Arctic Systems' ruling" (Tax Research UK, 2007).

⁴⁶ Vidar Christiansen, "Norwegian Income Tax Reforms" (2004) 2 *CESifo DICE Report* 9, 10.

⁴⁷ Christiansen, "Norwegian Income Tax Reforms" (2004) 2 *CESifo DICE Report* 9, 10.

⁴⁸ Christiansen, "Norwegian Income Tax Reforms" (2004) 2 *CESifo DICE Report* 9, 10.

⁴⁹ Sørensen, "Neutral Taxation of Shareholder Income" (2005) 12 *International Tax and Public Finance* 777, 780.

⁵⁰ Sørensen, "Neutral Taxation of Shareholder Income" (2005) 12 *International Tax and Public Finance* 777, 783.

income.⁵¹ The imputed return is called the rate-of-return allowance (RRA). Thus the taxable shareholder income is calculated by deducting the RRA from the nominal income from shares.

A rational RRA is the key to the success of the shareholder income tax. The Norwegian reform committee takes into account the after-tax interest rate and the stepped-up basis of the share at the start of the year. The stepped-up basis means the original acquisition price of the share plus all unused RRA accumulated from previous years.⁵²

The rationale for the shareholder income tax and income splitting for active owners is similar, both of which are trying to tax different types of income at different rates. Pure corporate profits and personal income are clearly taxed according to different rules. A notable feature of the system is that mixed profits should be dissected, in line with their economic essence, into the normal proportion of capital income and labour income, and then taxed accordingly.

The shareholder income tax focuses on the investment of physical capital and applies to all shareholders, which successfully avoids the problem of defining an active owner, and thus reduces the scope for income shifting.⁵³ On the other hand, it has been proved that the shareholder income tax is equivalent to a cash flow tax by Sorensen's deduction,⁵⁴ which means it is neutral to economic activities, investment and financing.

Summary of the proposals

In brief, this article recommends:

- in the long run, aligning income tax and National Insurance; or reforming the division between National Insurance classes to align the employed and self-employed⁵⁵ regimes to restore the relationship between entitlement to contributory benefits and contributions paid;
- in the short term, advocating the adoption of limited liability partnerships, and introducing a new shareholder income tax to prevent income shifting.

Conclusion

The existing system makes income tax and National Insurance treatment disproportionate between the employed and self-employed. The total cost of being an employee plus the employer's contribution is twice as much as that of being self-employed in terms of tax and National Insurance. The administrative and compliance cost is high for employers operating the PAYE system. The erosion of the contributory principle has been shown in the discussion of the existing situation in this piece. The reluctance of the Government to abolish the IR35 rule indicates the Government's lack of confidence in the existing system. However, lessons learned from the two alternative plans mentioned above do suggest there could be a different route to solve the issues addressed by IR35. Nevertheless, any adjustment to the treatment of the IR35 type corporation alone without looking into the essential underlying reasons for the unequal tax and National Insurance treatment between employed and self-employed would only perform as an expedient and complicate the tax system further.

Integration of the income tax and National Insurance would bring about genuine simplification of the UK tax system. The launch of the OTS at least shows that the Government has the courage to admit there are problems within the UK tax system and is willing to address them. The suggestion to integrating the income tax and NIC is not something new; however, now may be the most difficult time to start the integration of the two systems in the economic downturn. One obvious barrier is the high cost of alignment, which was estimated as high as £200 million.⁵⁶ In the short term, the action to integrate income tax and National Insurance can be started by sorting out the unnecessary differences between income tax and National Insurance. As long as the Government is sufficiently determined to bring this real benefit to UK taxpayers, the grand plan could be implemented incrementally. Although, during straitened economic times, taxation is expected to contribute more to the Treasury coffers, it should be borne in mind by policy-makers that the tax system should remain efficient, as well as equitable, horizontally and vertically.

⁵¹ Sorensen, "Neutral Taxation of Shareholder Income" (2005) 12 *International Tax and Public Finance* 777, 783.

⁵² Sorensen, "Neutral Taxation of Shareholder Income" (2005) 12 *International Tax and Public Finance* 777, 783.

⁵³ Crawford and Freedman, *Small Business Taxation* (2008), p.34.

⁵⁴ Sorensen uses mathematical models to prove his argument.

⁵⁵ The rate of National Insurance of self-employed could be increased in order to align with the treatment of employees.

⁵⁶ HM Treasury, *Income Tax and National Insurance Alignment: An Evidence-based Assessment* (2007), p.3.