THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Faculty of Taxation

Tax Representation

TAXREP 46/03

PRE BUDGET REPORT:
TAXATION OF OWNER MANAGED COMPANIES

Text of a letter submitted in December 2003 by Mark Lee, the Chairman of the Tax Faculty of the Institute of Chartered Accountants in England & Wales to the Paymaster General in response to the announcement in Paragraph 5.91 of the pre-Budget Report published on 10 December 2003.

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INTRODUCTION

1 I am writing to express our concerns about paragraph 5.91 in the Pre-Budget Report published on 10 December 2003 and to set out our suggestions to reduce the growing concerns in the small business community and among their advisers.

2 Paragraph 5.91 states that the Government will bring forward specific proposals in Budget 2004 to ensure that the "right" amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company.'

LACK OF CERTAINTY

3 The announcement has created considerable uncertainty principally because it did not identify what measures are being considered or whether all owner managers of small incorporated companies will be affected. It also suggests that any proposals would only be published in the Budget 2004 to take effect from 6 April 2004.

4 We have already been contacted by a number of our members who are concerned that for the next four months they will not be able to give full advice to small incorporated businesses. The expectation is that the "right" amount of tax means more than is paid at present.

5 I would ask that detailed proposals be published as a matter of urgency so that the uncertainty is reduced and so that businesses can make decisions. We would welcome the opportunity to see the detailed proposals at the earliest possible stage and provide input.

THE NEED FOR PROPER CONSULTATION

6 Any measures which are introduced need to be exposed to consultation beforehand. The Government is committed to consultation, as evidenced by the large number of consultation documents published in the Pre-Budget Report and the recent revision of the Code of Practice on consultation. We welcome this commitment. However, we are disappointed that proposals which could have a profound impact on the way owner managed companies are taxed will, apparently, be introduced without any formal consultation process. We think it is essential that any measures are first put out to consultation.

7 If changes are to be made, there are likely to be considerable implementation issues and practical details to consider, for example the need for any proposals to be simple and straightforward so that taxpayers can accurately self assess when preparing their tax returns. As has been found in the past when similar initiatives have been suggested (for example, the introduction of the IR35 rules) the lack of consultation at an early stage, led to considerable practical problems for all concerned – Government, taxpayers and tax adviser alike. We would like to work with you to keep the practical problems to a minimum.

TIMING OF IMPLEMENTATION

8 We are concerned about the proposed date of implementation. To ensure proper consultation in line with the Government's own guidelines, it seems that the intention to introduce measures in the Finance Bill 2004 requires a timetable that precludes detailed debate and the consultation referred to above.

9 If changes are to take effect from 6 April 2004 and if we exclude the Christmas holidays, this leaves only about three months for the proposals to be announced and for taxpayers to consider their position and make any necessary changes. If the announcement is not made until the Budget, this will leave almost no time to consider the position. Indeed, if the Budget takes place as it did last year after 5 April, there would be no time at all.

10 In view of the above, we request that the introduction of any measures is deferred until 6 April 2005.

PUBLICITY

11 This statement was for many incorporated businesses the most important statement in the Chancellor's speech. We were very surprised that there was no press notice on the subject in the Pre-Budget Report pack but that the crucial information was tucked away in paragraph 5.91 of the Pre-Budget Report.

12 At the very least, there should have been a press notice on the subject. Whatever plans are ultimately implemented, it would appear that substantial changes may occur to the way many small incorporated businesses are taxed and this may well affect how they are operated. To bury the reference to this proposal deep within the Pre Budget Report was unhelpful.

A POLICY REVERSAL?

13 We appreciate that policy issues are ultimately a question for Government. Nevertheless, we are concerned that the statement in the Pre Budget Report appears to indicate a major reversal in Government policy. Since 1997, the Government has introduced a number of powerful incentives which have encouraged owner managed businesses to incorporate. This policy was brought to a head with the introduction of the 0% corporation tax rate in the Finance Act 2002.

14 We expressed our concern with this policy in our representations on the 0% corporation tax rate included in the 2002 Finance Bill. We have reproduced in the Appendix our detailed comments which we made at the time. In particular, we said that:

We can no longer discern the policy of the Government towards small businesses. On the one hand the structure of the tax system seems increasingly to be encouraging such businesses to incorporate. On the other hand, where such businesses do incorporate, as happened in the IT industry where it became commercially impossible for a sole trader to obtain work, the Government seem to perceive incorporation as a form of tax avoidance.

15 We are not alone in being unable to understand the reasoning behind the apparent policy to encourage small businesses to incorporate. We note that similar concerns

were expressed in the debates on the Finance Bill 2002 that the regime was driving small businesses to incorporate. For example, one member of the Standing Committee said during the debate on clause 30 (the introduction of the 0% rate of corporation tax):

The situation is not sustainable. We do not want three million sole traders becoming incorporated and clogging up the system.

16 Others made similar comments.

17 In spite of concerns expressed about this policy, its implementation meant that taxpayers and their advisers could not ignore the clear tax advantages of incorporation. It was inevitable that many thousands of unincorporated businesses would incorporate given the incentives that were on offer. We are surprised that the Government appeared not to have anticipated the likely outcome of the clear policy incentives it had provided.

18 We would welcome the opportunity to consider with you the policy framework for encouraging growing businesses and to what extent the tax system should distinguish between incorporated and unincorporated businesses.

RELIEF FOR DISINCORPORATION

19 The inevitable consequence of any proposals will be that many businesses which are now incorporated will want to return to being unincorporated businesses. As the Government's clear policy until this point has been to encourage business to incorporate, we think it is only right that the Government should introduce a 'disincorporation relief' so that businesses can restructure in the light of this development without facing immediate tax charges.

20 Such a relief has been needed for many years and was one of the subjects of a joint DTI/Inland Revenue consultation paper published in July 1987, to which we responded in October 1987.

21 We believe that the Government needs to reconsider proposals for allowing businesses to disincorporate. In our response to the 1987 document, we stated that disincorporation should be a simple and straightforward exercise, given that the companies affected will have unsophisticated structures. We remain firmly of this view.

CONCLUSION

22 In view of the concerns we have expressed above, we would welcome a meeting with you or appropriate colleagues at the earliest possible opportunity to discuss our concerns and how they might be resolved. I have written in similar terms to Dave Hartnett direct.

ML/FH
19 December 2003

Appendix

Extract from TAXREP 17/02: The ICAEW Tax Faculty's representations on the Finance Bill 2002

What is Government tax policy?

19 We are concerned at the increasing divergence between high and increasing tax rates on small unincorporated businesses and a gradual reduction in the rates of tax of small companies. In some cases, albeit fairly rare, an individual may be taxed (including national insurance) at an effective rate of 48% (40% income tax plus 8% Class 4 national insurance) whereas the same profits earned by a company are taxed at significantly less than 20%. The profits of the small unincorporated business with a profit of under £10,000 will normally be taxed at 30% (22% income tax plus 8% national insurance) whereas if the business is incorporated the overall rate of tax will be nil, irrespective of whether the profit is ploughed back into the business or is distributed by way of dividend to its shareholders.

20 We can no longer discern the policy of the Government towards small businesses. On the one hand the structure of the tax system seems increasingly to be encouraging such businesses to incorporate. On the other hand, where such businesses do incorporate, as happened in the IT industry where it became commercially impossible for a sole trader to obtain work, the Government seem to perceive incorporation as a form of tax avoidance.

21 Thirty years ago earnings were taxed less heavily than investment income and the tax system incorporated provisions (the shortfall rules) to, in effect, force small companies to pay a minimum amount of after-tax profits as dividend rather than allow surplus funds to accumulate within the company. Today, earnings are taxed more heavily than investment income and the tax system encourages the accumulation of surplus profits within companies. We are not economists. We accept that it is possible that there may be good economic reasons why investment income should be regarded as more beneficial to the economy than earnings or that surplus funds should remain within a company, usually on bank deposit, rather than being distributed and used either for spending or investment in other businesses. However, we suspect that most people would be surprised if that is the case.

22 The problem for the small business is that it cannot keep changing its form of organisation in line with changes in approach to tax policy. Indeed, we believe strongly that the form of organisation of a business should not be affected by the tax system. It should be determined solely by commercial considerations, including ease of administration.

23 We submitted last year to the Inland Revenue a paper suggesting a format for a common system of taxation for small businesses which we believe would largely eliminate the form of organisation of such business being dictated by the tax system that prevails at the time the business is set up and its remuneration and dividend policies being dependant on the attributes of the tax system that prevail from time to time. We think that this ought to be the Government's objective for small businesses.

24 Similar dilemmas arise in relation to tax and National Insurance contributions and tax and social security benefits. At times the policy seems to be for the two sets of systems to converge as far as possible yet there seems little inclination to adopt a common set of rules for basic concepts such as the measure of income.