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**Research Report**

## Taxing work and investment across legal forms: Pathways to welldesigned taxes

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**Institute for Fiscal Studies**

**IFS Report R184**

**Stuart Adam  
Helen Miller**

# **Taxing work and investment across legal forms: pathways to well- designed taxes**

# Taxing work and investment across legal forms: pathways to well-designed taxes

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# Preface

This report is grounded in the economics of tax design and builds on decades of previous research, including early work undertaken for the Institute for Fiscal Studies (Meade Committee, 1978; IFS Capital Taxes Group, 1988a, 1988b, 1989, 1991, 1994), the more recent Mirrlees Review (Mirrlees et al., 2010, 2011) and a large body of theoretical and empirical research and policy analysis. But in writing this report we – the authors – were also informed by the expertise of a multidisciplinary Advisory Group which included researchers, policymakers and tax practitioners (see Box P.1) and by the views of a range of other stakeholders, including from the civil service, business, representative bodies and civil society organisations.

We thank everyone who engaged with us, especially the members of the Advisory Group, who gave up significant time to engage with this project and to share their expertise and perspectives. The report is undoubtedly better as a result of their input. But the views expressed in this report are those of the authors alone and do not necessarily represent the views of anyone else: we are not seeking to present a consensus view of the Advisory Group, and IFS has no corporate views.

While some of the ideas here will be viewed as radical in the UK, most are in operation (in at least some form) somewhere in the world. In many cases, the reforms we suggest are extensions of or changes to measures that are already in the UK tax system or have been in the past. We have not sought to lay out the precise way in which reforms could be legislated and we note cases in which care would need to be taken (for example, around avoidance opportunities), but we think all of the reforms we discuss would be feasible in the UK without creating unduly large administrative costs or scope for avoidance.

We thank the Nuffield Foundation for the core funding of this project. The Nuffield Foundation is an independent charitable trust with a mission to advance social well-being. It funds research that informs social policy, primarily in Education, Welfare and Justice. It also funds student programmes that provide opportunities for young people to develop skills in quantitative and scientific methods. The Nuffield

Foundation is the founder and co-funder of the Nuffield Council on Bioethics and the Ada Lovelace Institute. The Foundation has funded this project, but the views expressed are those of the authors and not necessarily the Foundation. Visit [www.nuffieldfoundation.org](http://www.nuffieldfoundation.org). We also thank the Economic and Social Research Council (ESRC) for financial support under the ESRC Institute for the Microeconomic Analysis of Public Policy at IFS (grant reference ES/T014334/1).

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#### Box P.1. Advisory Group members

The Advisory Group for this project comprised:

- **Steve Bond**, Professor of Economics, University of Oxford; Programme Director, Oxford University Centre for Business Taxation
  - **Bill Dodwell**, Tax Director, Office of Tax Simplification (OTS); formerly Head of Tax Policy, Deloitte
  - **Judith Freedman**, Professor of Taxation Law and Policy, University of Oxford; Chair, IFS Tax Law Review Committee
  - **Malcolm Gammie**, QC, One Essex Court
  - **Paul Morton**, formerly Tax Director, OTS; Non-Executive Board Member, HMRC
  - **Katy Peters**, Deputy Director for Personal Tax, HMRC
  - **Tina Riches**, formerly Partner, Smith & Williamson LLP
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  - **Edward Troup**, formerly Executive Chair and First Permanent Secretary, HMRC
  - **Robin Williamson**, formerly Technical Director, Low Incomes Tax Reform Group
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# Executive summary

The parts of the UK tax system that dictate how different forms of income are taxed are of central importance and are not fit for purpose. There is a large, unjustified and problematic bias against employment and labour incomes and in favour of business ownership and capital incomes. The tax treatment of returns to investment is a mess: incentives vary depending on the asset type, source of finance and legal structure involved and range from large subsidies to large penalties. And this is just the start; the list of problems is long. Some problems are high profile and periodically subject to tinkering. Others are so baked into the system that they are generally overlooked, yet are no less problematic.

There is growing pressure on the current system, notably as a result of rapid growth in the number of people working through their own business (business owner-managers have been the fastest-growing part of the labour market since at least the early 2000s) and increasing strain at the boundary between employment, self-employment and incorporation. Different groups are unhappy with the current system for different reasons: some worry about exploitation of the low-income self-employed, some about inequality related to low capital income taxes at the top of the income distribution and others about complexity and disincentives to enterprise. But these disparate groups seem increasingly united in thinking the current system is not working.

In this report, we seek to give people the information and tools needed to: (i) understand the range of problems with the current system for taxing different legal forms of work and how radical reform could largely or completely fix most of them; and (ii) devise smaller reforms that would move the system in the right direction while mitigating the trade-offs inherent in partial reforms.



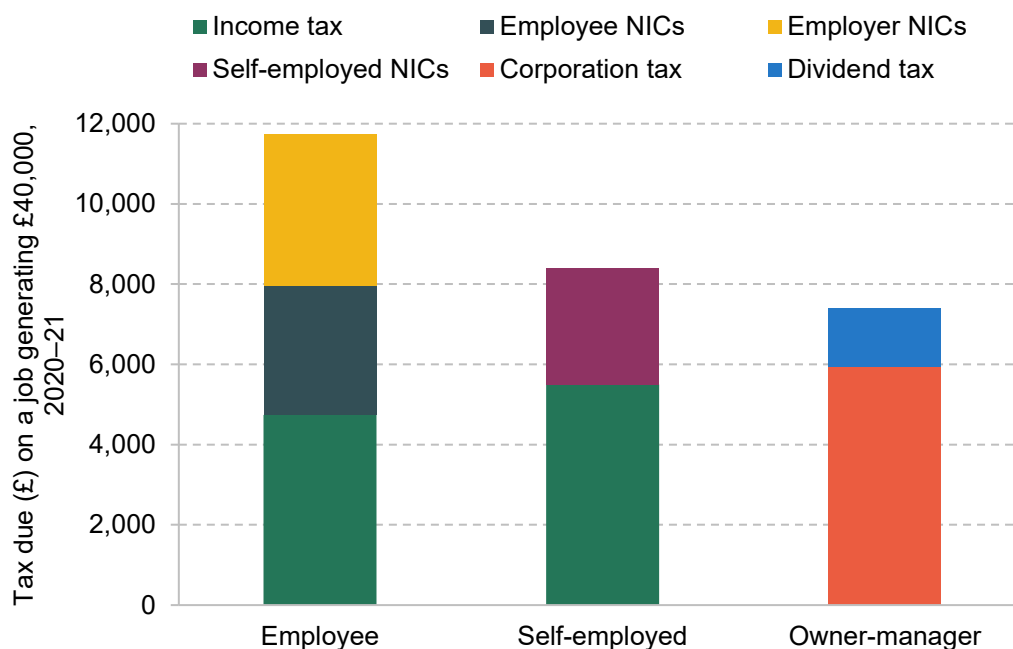
## Key findings

- 1 Preferential tax rates for business owner-managers cannot be justified by differences in social security benefits or employment rights and are poorly targeted at incentivising entrepreneurship. The differential tax rates create inefficiency, unfairness, complexity and revenue loss.
- 2 The tax base distorts investment decisions. Subsidies for borrowing sit alongside penalties for equity investment. Risk-taking is discouraged. These problems would be more severe if inflation and interest rates were higher.
- 3 The 'big-picture solution' involves reforming the tax base to remove distortions to the level, type and financing of investment while aligning overall marginal tax rates across all forms of income. There is more than one way to achieve these outcomes.
- 4 Partial reforms involve important trade-offs. Problems caused by flaws in the tax base would grow quickly if tax rates on income from business increased in isolation. There is a range of ways in which individual policy reforms could be packaged together to manage trade-offs.

## The need for reform

The UK imposes very different tax liabilities on income from work depending on legal form. Figure ES.1 shows an example of the tax penalty on employment relative to someone doing the same work through their own business. For a job generating £40,000, tax in 2020–21 is £3,300 (respectively, £4,300) higher if the job is completed through an employment contract rather than by someone who is self-employed (running their own company). Much of this results from the fact that not all incomes are subject to full National Insurance contributions (NICs), including employer NICs. But there are a range of other tax advantages, including preferential tax rates, available for business owners.

Figure ES.1. The tax penalty on employment



Note: Income tax is slightly higher for the self-employed than for employees because the latter are charged income tax on income net of employer NICs. Excludes trading allowance and employment allowance where applicable.

The tax advantage associated with different forms of income varies with the overall level of income. In the basic-rate tax band, dividends are the lowest-taxed form of income; above the higher-rate threshold, the biggest tax advantage is for capital gains.

The problems with this system can most easily be seen when similar work is being done by people who are employed, self-employed or working through their own company. Of course, people running a business are often not just doing similar work to employees: they may be employing people themselves, investing, trying out new ideas and taking risks. But the current tax base means that the tax treatment of these activities varies widely depending on factors such as the asset type, source of finance and duration and riskiness of investment as well as the legal structure involved. Notably, the design of the tax base creates an incentive to borrow, a disincentive to invest (equity) in companies, a bias towards investing in some assets rather than others, a disincentive to take risks, and an incentive to hold onto assets for longer than commercial decisions would dictate.

Varying tax rates by legal form and accepting a poorly designed tax base creates four broad types of problem:

- **Unfairness.** People generating the same overall level of income can attract very different tax bills according to the legal form in which they work.

Much of the policy discussion focuses on how tax advantages for business owners affect the relatively low-income self-employed (including tradespeople and ‘gig economy’ workers) or genuinely entrepreneurial businesses. But the tax advantages also apply much more broadly, including, for example, to many senior people working in legal and financial services firms. Income from business – especially capital gains, dividends and partnership income – accrues disproportionately to the top 1% of taxpayers. Tax advantages here can be very large. For example, the average income of a partner working in the financial services industry is £308,000 and that income will attract over £20,000 less in tax each year than if the same job were performed by an employee. At both high and low income levels, it seems unfair to tax employees more heavily than those working through their own business.

- **Economic inefficiency.** By distorting a range of decisions, including over how to work and which investments to make, our tax system ultimately reduces society’s aggregate output and well-being.

While tax is rarely the main factor influencing people’s decisions, there is strong evidence that it does affect behaviour. Usually, it would be better for people to do what they think best personally and commercially.<sup>1</sup> Tax policy should not, for example, encourage people to become self-employed (or employers to use self-employed contractors) if they would otherwise be happier and more productive with an employment contract. The rapid growth in the number of small businesses in the UK is often hailed as a success. But this is not obviously true and this narrative sits uneasily alongside evidence that the UK has a longer tail of low-productivity businesses than other countries.

<sup>1</sup> Market failures can sometimes justify the government’s stepping in to try to influence people’s choices in the wider public interest, but even where behaviour change is sought as a desirable policy outcome, the policies can have unfortunate side effects.

The large tax rate differences between legal forms and the inefficiency they create are easy to see. But the current tax base also affects the behaviour of small businesses and their investors in many other ways – the level of investment and risk-taking, asset allocations and financing decisions – which also affect individuals' welfare and aggregate productivity. These problems are less widely understood and there is less evidence on their exact magnitudes – but that in itself does not make them less important. They are, however, less pressing in the current environment, with low capital income tax rates and ultra-low interest rates, than they would be if either of those increased.

The tax base obviously matters less when tax rates are low anyway: if tax rates were almost zero, they could not do much damage whatever the base (though, as we argue below, reduced tax rates on capital income are less well targeted than base reform at reducing distortions to investment decisions).

The inefficiencies created by the tax base are also smaller when interest rates are low. Many of the tax base problems arise when income is taxed, or costs deducted, at the 'wrong' time and there is no adjustment to compensate for this. When interest rates are low, these defects are less severe because the difference in value between payments made at different times – and the (missing) interest adjustment that would compensate – are smaller. For example, the capital allowances schedule determines how quickly investment costs can be deducted from taxable profits; if interest rates are low, the value of being able to deduct costs sooner rather than later is smaller, so having the 'wrong' capital allowances schedule has less effect. The same applies to most (though not all) of the distortions to the tax base.

- **Lost revenue.** Government revenues are reduced substantially as a result of providing reduced tax rates for business owners, relative to the tax that would be levied if they were employees.

Based on official statistics (from before the COVID-19 crisis and some recent policy reforms), we estimate that revenues lost through lower tax rates on income from business were around £15 billion per year. Of course, this revenue cost to the government has a corresponding £15 billion gain to the taxpayers who benefit from this largesse. However, the tax advantage is worth less to taxpayers than the £15 billion of tax they save, because in order to get it some

of them are doing things they would rather not. The distortions to behaviour mentioned above are the true cost to society.

- **Administrative burden and complexity.** The presence of boundaries in the tax system creates the need to devise, administer, comply with and police rules to distinguish the different legal forms – not only whether someone is really working as an employee but also, for example, whether a particular receipt represents income or capital gain and whether a particular outgoing is a current expense or an investment. These, in turn, impose costs by diverting officials, taxpayers, accountants and occasionally the courts from more productive activities.

The current system persists in spite of these four types of problem, in part because of a widespread belief that the system is justified – i.e. that there are benefits that offset the costs imposed by differentiating tax by legal form. However, none of the common arguments holds up. Levying lower taxes on the self-employed cannot be justified by differences in publicly funded benefits (the differences in benefits are far smaller than the tax advantages) or by differences in employment rights (which make employment more attractive to workers but less attractive to potential employers). Lower tax rates are also poorly targeted at boosting entrepreneurship.

### Tax problems could be fixed

There is a theme to the policy mistakes that have been made in the past. Effectively, policymakers (in the UK and many other countries) have been trying to use capital tax rates to pursue two goals:

- 1 **‘tax all income the same’** – this creates neutrality across income sources, in the interests of fairness, simplicity, avoiding distortions and minimising avoidance;
- 2 **‘don’t discourage saving and investment’** – this creates neutrality with respect to when people spend their money and how much investment takes place, and also with respect to different types of saving and investment.

These two goals appear to be in tension. The desire to create a fair system and stop tax-motivated changes in legal form suggests that capital income tax rates should be similar to labour income tax rates. But the desire to ensure that tax does not discourage saving and investment is often used to support lower rates. UK capital

gains tax (CGT) rates – which have been moved up and down over time – provide a clear example of how politicians have chosen different points on this perceived trade-off. What we are left with is an awkward compromise that achieves neither aim and is therefore subject to constant tinkering. Moreover, the compromise creates many boundaries in the tax system – including between self-employment and employment and between different types of capital income – which then require great effort to define and police. In recent years, there have been concerted attempts to address the problems created by having differential tax treatment of legal forms through ‘IR35’ rules that determine what should fall on each side of a legal boundary. But this approach is failing, and will continue to fail, because it cannot overcome the core problem: there is no coherent principle underlying the tax distinction between legal forms.

We argue that these two goals can both be achieved and the tension overcome, by using tax rates *and* the tax base. Building on a large body of economic research, the ‘solution’ was laid out by the IFS-led Mirrlees Review of the UK tax system (Mirrlees et al., 2011). Specifically, the solution entails:

- 1 **Taxing income from all sources under the same overall marginal rate schedule.** This achieves the first objective and would imply that the bars in Figure ES.1 were all the same height.

It is aligning overall rates – including all layers of tax – that matters. There are many combinations of rate changes that could achieve this and, overall, tax rates could be levelled up to current employment tax rates, levelled down to current capital tax rates, or set somewhere in between. To the extent that the discrepancies are caused by levying employer NICs only on payments to employees, the natural solution would appear to be to levy an equivalent tax on payments to other service providers as well (sometimes called an ‘engager NICs’). In practice, that is not an attractive approach. First, unless the tax were levied on payments to *all* suppliers of goods and services (however big), it would imply another boundary in the tax system, raising many of the same concerns that are present at the current boundary between employees and the self-employed. And second, business owners need to be able to deduct business costs from their taxable income, which is difficult to achieve where the tax is levied on their engager and when they work for multiple engagers. A better solution – and one that is in place in other countries – would be to increase tax rates on the *receipt* of income from business (for example, to increase rates of

self-employed NICs to align with the overall rate of employee and employer NICs).

- 2 Reforming the tax base to **give full deductions from the tax base (at the corporate and personal levels) for amounts saved and invested**. This achieves the second objective.

The tax base is a more effective tool than tax rates for ensuring that taxes do not discourage investment. The tax base can be designed to ensure that marginal investments – those that are only just worthwhile – are not taxed, minimising the effect of tax on investment decisions, while ensuring that tax is paid in full on more profitable projects, which are likely to go ahead anyway. In contrast, reduced rates can still deter marginal projects while also giving unjustified support to non-marginal activities. There are broadly two different ways to produce a neutral tax base that would remove disincentives to save and invest as well as removing a range of distortions between different types of assets and sources of finance, removing the disincentive to move money from one asset to another and ensuring that tax incentives do not vary with inflation. We discuss the two approaches in detail in Chapter 3. In summary, a **‘cash-flow’ approach** would give 100% up-front tax deductions for all savings and investments and tax all incomes when they are received. The alternative **‘deferred-allowances’ approach** would provide a stream of annual tax allowances for a risk-free return to money saved or invested, which would be as valuable as a 100% up-front allowance. Each ensures that all investment costs are fully deductible from tax. Under either approach, there would need to be reform of the tax treatment of borrowing, either to keep the current interest deduction but also add a deduction for repayments of principal and tax all amounts borrowed, or else to modify the interest deduction so that only interest payments in excess of a risk-free rate of return on the outstanding loan would be deductible. Alongside these reforms to the tax treatment of investment and finance costs, tax relief for losses should be made as nearly as possible symmetric to the taxation of profits/gains, to minimise disincentives for risk-taking.

With a reformed tax base, tax rates on capital income could be increased with little concern about weakening incentives to invest and take risks.

Not all trade-offs can be avoided. Our proposals would not remove disincentives to work, the scope to use companies to split income with a lower-taxed spouse, the

need to distinguish between business purchases and personal consumption, or the challenges posed by international mobility. But for a number of major challenges that have plagued governments for years, we believe it is possible to have our cake and eat it. Our proposed solution may never be reached in full, but at the very least it provides a benchmark that can guide policy.

### Reforms can be made in the right direction

We set out the components of a well-designed tax system; it would be possible, and perhaps more realistic, to start by introducing just some of these components, rather than radically reforming the whole system in one go. But in choosing which options to pursue, it is crucial to approach the tax system as a system. Attempting to solve one narrow problem in isolation – such as by adjusting only the treatment of one legal form or by introducing different tax regimes for a subset of small businesses – can be the policy equivalent of ‘whack-a-mole’: the particular problem may be fixed but at the expense of another one popping up elsewhere in the system.

With this concern in mind, we lay out a number of example reform packages – summarised in Table ES.1 – that seek to combine components of our long-run ideal. These illustrate, and in some cases mitigate, some of the trade-offs inherent in partial reform.

The most salient problems currently are those related to differences in tax rates across legal form. Some may wish to address these problems even without reforming the tax base; packages 1–5 offer suggestions in this vein. Such rate changes on their own may be worthwhile (and would reduce distortions to the choice of legal form), but would worsen the distortions caused by the tax base. The efficiency costs created by a distorted tax base rise more than in proportion to tax rates, because low tax rates only change behaviour when the decision is marginal anyway; higher tax rates discourage not only more activities, but also more valuable activities. This means that even problems that are seen as small at the moment could become much larger. The problems created by penalising equity finance and subsidising debt finance, by failing to give full relief for losses and by discouraging transactions that would trigger a tax liability would all be worse at higher tax rates. This could in turn undermine the stability of increases in tax rates. This has already been seen with capital gains tax, where rates have often been raised with a view to making the system fairer only to be cut again when concerns are raised about the



effects of higher rates on investment. Fixing the tax base would remove one of the main causes of the yo-yoing of capital gains tax rates.

**Table ES.1. Example packages**

Combinations of rate changes	
1.	Reduce employer NICs; increase employee and self-employed NICs
2.	Levy NICs (or equivalent tax) on dividends (and perhaps other taxable capital income) in exchange for reducing NICs rates
3.	Increase income tax (including on dividends) and CGT; reduce NICs
4.	Align tax rates on capital gains with those on capital income
5.	Remove big separate allowances for dividends and capital gains
Combinations of higher rates and a narrower base	
6.	Increase headline tax rates in return for broadening the annual investment allowance
7.	Increase dividend tax and CGT rates and introduce a new investment vehicle offering income tax relief for investment, with tax on withdrawal of funds instead
8.	Increase headline tax rates and allow losses to be offset more flexibly
9.	Increase CGT and dividend tax rates and reintroduce inflation indexation
Other combinations	
10.	Increase self-employed NICs in return for greater access to state benefits
11.	Remove CGT uplift at death, in conjunction with reforms in other policy areas, such as inheritance tax

Given the drawbacks of raising tax rates in isolation, we think it is particularly attractive to pair increases in tax rates on income from business (such as increasing rates of self-employed NICs, dividend tax or CGT) with reforms to the tax base, such as allowing more generous deduction of investment costs or more flexible loss offsets. Packages 6–9 offer examples of this. Packages 10 and 11 set out other possible policy combinations, highlighting how unfortunate anomalies in the current tax system could be addressed in combination with reforms in related areas of policy.

These should be seen as examples of steps that could be taken towards a better-designed tax system. We have picked examples that start to deal with the large tax rate differences across legal forms and (in packages 6–9) to tackle some of the largest problems with the tax base. But there are other reforms that could be chosen and many ways to package reforms together. There is no one ‘right’ set of packages or pathway to reform and we are not particularly wedded to any of these specific examples. Instead, our aim is to show how reforms can be crafted and to provide people with a framework and the necessary information to form their own packages and assess the trade-offs associated with different options.

Different groups will favour different reforms or packages depending on, among other things, their views on which parts of the current system are most problematic. Although we do not do it in this report, packages could be chosen, combined or designed with a particular theme or motivation in mind. For example, one could see packages 6, 7 and 8 (or other packages in the same spirit) as part of a programme of reform to support entrepreneurship. These packages move away from blanket tax reductions for anyone whose income is labelled as ‘business income’ towards targeted measures that reduce the tax penalty for those who invest or take risks. In a similar spirit, a programme of reforms could be put together with the aim of tackling tax breaks at the top of the income distribution or making the tax system simpler.

One important factor to consider in plotting tax base reform is the likely path of interest rates. As highlighted above, many distortions within the tax base are larger when interest rates are higher. At the moment (with historically low interest rates), the benefits of reforming some parts of the tax base are smaller; the flip side is that the exchequer cost of fixing those parts would also be smaller. If interest rates are expected to be low for the next few years but rise some time later, there is a case for

introducing reforms now rather than waiting, so that they can be implemented, tested and bedded down while they are relatively inexpensive to the government and the costs/risks associated with any glitches are lower for taxpayers and the exchequer. In so far as interest rates are expected to remain low in the longer term, that should shift the balance of priorities towards fixing those parts of the system that are not less problematic at lower interest rates – specifically, towards aligning tax rates, making loss offsets more flexible and ending CGT uplift at death – with other aspects of tax base reform given lower priority.

### There will be losers and difficult choices

Any meaningful reform would create losers as well as winners. It is worth highlighting, broadly, which types of people would gain or lose under our ‘full proposal’ (and many of the smaller packages we lay out).

Employees and employers would gain, to the extent that tax rate alignment were pursued by reducing tax rates on employment rather than (or as well as) increasing tax rates on business income.

Where individuals are effectively only generating labour income and taking it in the form of self-employment income, dividends or capital gains, the policies we propose would represent a tax increase (felt by them and those using their services); if capital income tax rates were fully aligned with labour income tax rates then in some cases it would be a very large increase. There is no way to effectively reform the tax treatment of legal forms without making those groups worse off, although this could equally be described as removing the tax advantages they receive under the current tax system. Increasing tax on the work they do is of course undesirable in itself, but there is no good reason to tax work less heavily if it generates business income than if it generates employment income. Increasing tax on business income while reducing tax on employment income would even out the treatment across legal forms without increasing tax on work overall.

One group about which there would likely be significant concern is the low-income self-employed, including those working in the so-called gig economy. Many in this group are struggling with low incomes and precarious working conditions and have done particularly badly since the 2008 financial crisis and during the COVID-19 crisis. The lowest earners will already be paying little or no tax on their incomes, and we do not propose to change that. But our full proposal includes higher tax

rates on still relatively modest self-employment income. Where people are being pushed into self-employment by firms wanting to avoid paying employer NICs (and providing employment rights) to those who do work for them, increasing their tax rates might seem at best a counterintuitive response and at worst downright perverse. Nevertheless, we think it is the right thing to do. In some cases, the tax rise may be passed on to engagers as self-employed workers increase the amount they charge. If, in the current system, engagers are benefiting from the lower tax rates, we would expect them to bear the cost of increased taxes. In other cases, tax rises would be felt by the workers themselves. But note that in these cases the workers will also be the ones currently benefiting from preferential rates – they will already be charging more for their services than an equivalent employee could command. At any income level, there is no reason for the tax system to favour those working through their own business over employees in that way. Where there is concern about hard-pressed low-paid workers, we should reduce taxes for employees and the self-employed equally, not levy higher taxes on employment that push it out of the reach of many. As argued in the government-commissioned Taylor Review (2017), ‘treating different forms of employment more equally in the tax system would be fairer, more economically efficient and support better quality work’. Of course, the market would take time to respond to tax changes, so there is a case for preannouncing changes and implementing them gradually so that people and firms have time to adjust.

For individuals who are making genuine business investments and taking risks, there would be offsetting effects from our proposals. There would be more generous treatment of investment costs and more risk-sharing with the government. Many of those making relatively low returns (for example, those operating in highly competitive industries and those taking risks that do not pay off) would see lower taxes – and this is where tax is likely to make most difference to whether projects go ahead. Those making very high returns – which could reflect some combination of effort and skill, privileged access to scarce opportunities, and luck – would see higher taxes alongside the improved investment incentives.

There is no pain-free way to fix the current tax system. But keeping the status quo is also a choice – one that unfairly penalises ordinary employees and investors, as well as creating significant inefficiency and administrative costs that make us all poorer. A challenge for those who do not like the particular reform packages we

highlight is to devise alternatives of their own. Rejecting all reform means choosing the current system; surely we can do better.

### Tax reform in the shadow of COVID-19

The COVID-19 disaster has brought many challenges that will last for decades to come. But COVID-19 does not alter the fundamental problems we have identified. Nor does it change the big-picture solution. We lay out a range of problems that are driven by flawed tax policy and that will only be fixed by better tax policy.

It will be even more important to fix these problems following the crisis. We are likely to see a move towards higher taxes in the medium run, both in light of a higher structural budget deficit and in response to demands for higher spending. Higher taxes have the potential to exacerbate the problems caused by structural weaknesses in the system, and make it even more important to design tax policy well. There may also be a greater focus on economic inequalities, the quality of work and a fair distribution of the tax burden. The issues we highlight matter for all of these.

Of course, COVID-19 will change the political economy of tax reform.

In Spring 2020, when announcing the introduction of the Self-Employment Income Support Scheme (SEISS), Chancellor Sunak laid the groundwork for future rises in taxes on the self-employed, saying: ‘in devising this scheme – in response to many calls for support – it is now much harder to justify the inconsistent contributions between people of different employment statuses. If we all want to benefit equally from state support, we must all pay in equally in future’. The SEISS can be seen as evidence that not only are standard state benefits almost as generous to the self-employed as to employees, but the unspoken promise of emergency support the government provides to the self-employed is comparable to that for employees. On average, the SEISS has been roughly as generous to the self-employed as the Coronavirus Job Retention Scheme (the furlough scheme) has been to employees. But some self-employed people have been overcompensated by the SEISS (resulting in a higher income than they had before the crisis) while others have fallen through the gaps: around 40% of those receiving any self-employment income before the crisis (18% of those receiving more than half of their income from self-employment) are ineligible for the SEISS. And most company owner-

managers have received little or no government support of this kind. This will make it harder to raise taxes on these groups. Yet the fact that the government has struggled to target support for the self-employed accurately during this crisis is a weak argument for maintaining across-the-board low tax rates for business owner-managers.

In light of the challenges ahead, reformed taxes offer a significant prize. Better-designed taxes allow us to raise more revenue with less economic harm. And more specifically, we could choose a path that helped with the economic recovery. We lay out reforms that would improve incentives for businesses to invest, employ people and take risks, and would do less to push people away from employment and into other forms of work that they may not prefer. Policymakers could choose a reform pathway that helps improve the structure of the tax system while also aiding the recovery and the rebuilding that are to come.

# 1. Introduction

The parts of the UK tax system that dictate how different forms of income are taxed are of central importance and are not fit for purpose. There is a large, unjustified and problematic bias against employment and labour incomes and in favour of business ownership and capital incomes. The tax treatment of investment is a mess: incentives vary depending on the asset type, source of finance and legal structure involved and range from large subsidies to large penalties. And this is just the start; the list of problems is long. The problems are not new, but they have been growing and becoming more prominent because there has been rapid growth in the number of people working through their own business.

## The purpose of this report

This report is intended to be a resource for those wishing to understand the problems with the UK tax system as it applies to work and investment done through small businesses and to study the potential solutions. The report does three things.

First, we set out **why the tax differences across legal forms and types of income and the treatment of different forms of investment are problematic and unjustified**. This is covered in Chapter 2.

Second, in Chapter 3, we explain our vision for a well-designed set of taxes that would remove (or massively reduce) many of the problems. This is a **long-run ideal** and differs substantially from the current system. But we think it important that all incremental policy reforms be tethered to a clear sense of how the tax system should ideally be designed, even if achieving the ideal end goal in full is deemed out of reach within policymakers' typical horizons. There is more than one version of our preferred solution and we lay out the relative merits of different options. Section 3.2 discusses how tax rates would need to be changed, while Section 3.3 considers the tax base; Tables 3.7 and 3.8 summarise the components of comprehensive reform to the tax base.

Third, we discuss in Chapter 4 how packages of smaller reforms could be designed to start tackling the main problems and get the UK moving towards a set of well-

designed taxes. Neither the problems nor the big-picture solution we lay out is new. Yet tax reform in this area has been unsatisfactory for decades. There are lots of bad ways to reform tax, and too often governments have chosen one of them. Delivering all the components of an ideal system at once would be daunting and risky, but enacting any one of them in isolation risks the policy equivalent of ‘whack-a-mole’: one problem is solved but another one pops up elsewhere in the system (we discuss this further below). Our aim in Chapter 5, therefore, is to provide specific **examples of how incremental policies can be packaged together in ways that illustrate and manage the trade-offs inherent in changing policy.**

There is no one ‘right’ set of packages or pathway to reform and we are not particularly wedded to any of the specific examples we lay out. Instead, our aim with these examples is to show how reforms can be crafted and to provide people with a guide to help them construct their own packages and assess the trade-offs associated with different options.

Any meaningful reform would create losers as well as winners. There is no pain-free way to fix the current tax system. But keeping the status quo is also a choice – one that unfairly penalises ordinary employees and investors, as well as creating significant inefficiency and administrative costs that make us all poorer. A challenge for those who do not like the particular reform packages we highlight is to devise alternatives of their own. Rejecting all reform means choosing the current system; surely we can do better.

### The population of interest

Our focus in this report is on small businesses and the individuals who run them. This includes both the self-employed (sole traders and partnerships, both forms of unincorporated business) and owner-managers of companies (incorporated businesses).

Small businesses are an area of particular current concern, not least because owner-managers have been the fastest-growing part of the UK labour market since at least the early 2000s.<sup>2</sup> But, because business owners sit at the intersection of labour and capital taxes, the solutions we describe necessarily affect many taxes and would have benefits far beyond the small business context.

<sup>2</sup> Source: Cribb, Miller and Pope (2019).



### Who are business owners and how many are there?

In other work we provide a detailed description of the small business population and the growth that has taken place in recent decades (see Adam, Miller and Pope (2017), Cribb, Miller and Pope (2019) and Giupponi and Xu (2020)). Here we provide a summary.

In 2015–16 (the most recent year for which we have data from tax records), there were about 5 million people with some self-employment income (of whom about 3.7 million got over half of their income from self-employment) and 2 million company owner-managers. Both groups have grown since the mid 1970s, and have been growing continuously since the early 2000s: in 2000–01, there were around 4 million people with some self-employment income and 0.9 million company owner-managers. Growth in self-employment has been driven entirely by sole traders – the number of partners (owners of multiple-owner unincorporated businesses) has been falling – and growth in the number of company owner-managers has all been in one-director companies, and increasingly skewed towards those with no employees.<sup>3</sup>

The share of business owner-managers whose businesses employ others has been declining since the late 1980s. Survey data show that nearly half (44%) of sole traders and company owner-managers had employees in 1975, compared with just 15% in 2019 (Giupponi and Xu, 2020) – a profound shift.

The growth in business owner-management in the UK has been remarkable by international standards. Since 2000, the majority of other OECD countries have experienced little change or a reduction in the share of self-employed people hiring no employees. As of 2019, the UK had the second-highest number of self-employed people with no employees (as a percentage of the total workforce), with only Italy

<sup>3</sup> Source: Cribb, Miller and Pope (2019). Defining and counting business owner-managers is not straightforward. The statistics cited in this paragraph include all unincorporated business owners. Given the available data from tax records, we define an owner-managed company in these statistics as a company that has either one or two directors. In 2015–16, there were 26.6 million employees, such that the self-employed and company owner-managers were around 20% of the workforce. Excluding those who received less than half of their income from self-employment, business owner-managers were around 17% of the workforce. Business owner-managers are not perfectly captured in survey data, but such data are more up to date and available for a longer period than tax records. According to the most recent Labour Force Survey – as analysed by Giupponi and Xu (2020) – sole traders and (self-identified) company owner-managers were 14% of all UK workers in 2019, up from 8% in 1975.

higher (at 15%). And since 2000, only the Netherlands saw a larger rise in self-employment (see Giupponi and Xu (2020)).

The business owner-manager population has always encompassed a large variety of business models and spanned the entire income distribution. People using a business legal form (rather than being employees of another business) include all sorts from taxi drivers, plumbers and local shop owners, to IT consultants, doctors and partners in law and accountancy firms, to those running genuinely innovative businesses. However, to the extent that it is possible to describe the stereotypical owner-managed business, it is one that is likely to survive for less than five years, that creates an income well below the average for employees and that neither invests nor employs others. Sole traders have particularly low incomes: their mean total income in 2015–16 was £21,000 – over £10,000 lower than for employees. After excluding income from employment (conducted alongside their business), investments and pensions, their mean income from self-employment alone was just £12,100. The self-employed saw large falls in income during the financial crisis (Cribb, Miller and Pope, 2019) and during the COVID-19 crisis (Delestre et al., 2020; Blundell, Machin and Ventura, 2020). In contrast, partners have significantly higher average incomes than employees, at around £74,000 – and the average income of a partner working in the financial services industry is £308,000 (which will attract over £20,000 less in tax each year than if the same job were performed by an employee).<sup>4</sup> Company owner-managers also have significantly higher average incomes than employees and are more likely to invest and employ others. Overall, income from business – especially capital gains, dividends and partnership income – accrues disproportionately to the top 1% of taxpayers (Joyce, Pope and Roantree, 2019; Advani and Summers, 2020). But there is enormous heterogeneity across and within all legal forms.

### How our proposals relate to other groups

We highlighted above that there is a danger that trying to solve any one problem in isolation will simply lead to another problem arising elsewhere in the tax system. This is a particular concern when looking at small businesses, because the taxation of employees, the self-employed and company owner-managers sits precisely at the

<sup>4</sup> Statistics from Cribb, Miller and Pope (2019). This calculation assumes that the total income generated and paid out is the same for the partner and the employee. This means partnership income of £308,000 equates to a salary plus employer National Insurance contributions of £308,000 for the employee.

point where many parts of the tax system come together. Incentives to switch between legal forms depend on the bases and rates of income tax (including the treatment of dividends), National Insurance contributions (NICs), corporation tax and capital gains tax (CGT). Changing any one of these has far-reaching effects: tax rates on earnings affect all employees, not just those who might otherwise set up a business; corporation tax affects all companies, from one-man bands to multinationals; and taxation of dividends and capital gains affects portfolio shareholders and buy-to-let landlords as well as business owner-managers.

In this report, we have purposely focused on small businesses and their owners. But our big-picture solution is drawn from the IFS-led Mirrlees Review, which considered the tax system as a whole. As such, the solution that we put forward does take account of how the proposals would affect the whole of the economy. In fact, one big advantage of these proposals is that they can – indeed, should – apply beyond the small business context. That is, they would fix an even wider set of problems than the ones discussed in this report. Perhaps most notably, the reforms could be applied to (and fix problems associated with the taxation of) the full range of businesses, from sole traders to giant multinationals, with no need for separate regimes or arbitrary boundaries.

In choosing which reforms to implement – or the types of packages to build – policymakers could be guided by the path they would like to take in other areas. For example, if they have a view on how to treat interest deductibility for multinationals, this could inform which path to take for small business. In some cases, it would also be possible to enact a reform only for small businesses or their owners and not extend this to, for example, multinationals, portfolio shareholders or landlords. We advise caution in doing this without a very good reason, however. Drawing a new tax boundary – for example, between ‘big’ and ‘small’ firms – would introduce new problems of complexity, inefficiency and unfairness (or shift the existing problems to that new boundary); it is exactly these types of problems that we are trying to remove.

## 2. Problems with current taxes

In this chapter, we summarise the features that characterise a well-designed tax treatment of different legal forms of work and different investment activities and set out the ways in which the current system falls short.

The current tax system creates unfairness and inefficiency, leads to a loss of government revenue and is more administratively burdensome than necessary. We highlight that these problems arise where the tax system is not neutral, meaning that similar activities are treated in different ways. We set out the case for neutrality in Section 2.1 and by contrast lay out the problems with the current system in Section 2.2. In principle, there can be cases where the benefits of treating similar activities differently outweigh the costs; we discuss this in Section 2.3. The current tax differences are not justified, however. In particular, none of the three common arguments in favour of differentiating tax by legal form holds up. Levying lower taxes on the self-employed cannot be justified by differences in publicly funded benefits (the differences in benefits are far smaller than the tax advantages) or by differences in employment rights (which make employment more attractive to workers but less attractive to potential employers). Lower tax rates are also poorly targeted at boosting entrepreneurship. Arguably the best argument in support of lower tax rates on business owners is that these groups are simply more responsive to tax rates, but that in itself is controversial and fraught with difficulties; we return to discuss this in Section 2.3.

## Key findings

- 1 A good rule of thumb is to aim to make taxes neutral – similar activities should be treated similarly. This will tend to be simpler and fairer, and mean that decisions over work and investment are driven by personal and commercial considerations rather than tax.
- 2 UK taxes are non-neutral in many problematic ways. There are much lower tax rates on income from business than on income from employment.
- 3 Investment incentives vary across assets, financing and legal form. Debt-financed investments tend to be subsidised, investments financed from new equity are disincentivised and there is a disincentive to take risks.
- 4 There are reasons to deviate from neutrality. In some cases, tax can be used to improve market outcomes; in some cases, differences in the way different groups behave mean they should be taxed differently. But the benefits of special tax treatments must outweigh the costs for them to be worthwhile, and the hurdle for departing from neutrality should be high.
- 5 Lower rates of tax for business owners are poorly targeted at incentivising entrepreneurship and investment. Improving incentives by reforming the tax base would be better targeted.

## 2.1 Benchmark: a neutral tax system

Tax systems should aim to achieve revenue-raising and distributional goals as simply as possible, as equitably as possible, and at the lowest possible cost to taxpayers.

The cost to taxpayers of providing revenue includes not just the money they hand over and the resources they spend complying with their obligations, but the effect on their well-being of how the tax system leads them to behave. The loss to taxpayers in excess of the tax they pay is the economic efficiency cost (aka deadweight cost or excess burden) of taxation, and it arises from people changing their behaviour in response. To give an extreme illustration, if a tax is so high that everyone stops doing the taxed activity, then the government gets no revenue at all but people are clearly worse off than if they were doing as they pleased. A more efficient tax system can raise the same revenue with lower taxes.

With simplicity, equity and economic efficiency in mind, a good rule of thumb is that a well-designed tax system should strive to be neutral.

Neutrality means taxing similar activities similarly.<sup>5</sup> This is in contrast to the common feature of tax policy in drawing essentially arbitrary boundaries between activities that are taxed at different rates (such as employment versus self-employment, income versus capital gains, small versus large shareholdings). Departing from neutrality tends to make the tax system more complicated (as boundaries need to be defined and policed) and less fair (as people doing very similar things can face very different tax liabilities). It also makes the system less efficient as people change their behaviour to fall on the lower-taxed side of the boundary – a change which they would rather not have to make and which costs the exchequer money, meaning higher tax rates (and greater welfare loss) to raise the revenue required. Neutral taxes are ones that minimise interference with people's free choices and thereby ensure that decisions are driven by what makes commercial sense rather than by the tax system.

In the context of considering the taxation of work that happens in different legal forms, a neutral tax system would be one that did not affect any of the following decisions:

- **Legal form**, i.e. whether work happens through an employment contract or through a business organisation.
- **The amount saved and/or invested.**

<sup>5</sup> For further discussion of neutrality as a rule of thumb, including how it relates to the principles that underlie a well-designed tax system and what it means for other parts of the tax system, see Mirrlees et al. (2011, ch. 2).

- **Asset choice.** At the personal level, this includes the choice between investing in one's own business or in other assets, such as a pension, housing or other shares; at the business level, it includes choices over whether to invest in plant & machinery, buildings, cars, training, research & development (R&D), intellectual property (IP), branding/advertising, other businesses, cash holdings etc. As well as the type of asset, it also includes the choice of how long to hold on to a particular asset and when to trade it for another.
- **Form of return,** i.e. whether to receive income in the form of salary, dividends, capital gains or another form.
- **Source of finance.** At the business level, whether to use equity (which could be of an owner-manager or other investors and could be new or retained equity) or debt.
- **Level of risk-taking.**

The idea that we should strive to have a neutral tax system runs counter to the common belief that the role of taxes is to encourage desirable activities. But the fact that some forms of activity (such as employment or investment) are 'good' does not necessarily mean that we want more of them. It is possible to have too much of a good thing. For example, not all investments are profitable and, at the moment, commercially unviable debt-financed investments can be made profitable by the tax system, as we will see; that is undesirable. People will presumably do what is good in their own eyes without further prompting; the question is 'When will that not be in the wider public interest?'.

Neutrality is not always the most economically efficient option. There are some reasons to deviate from it, which we discuss in Section 2.3. But they are exceptions. Given the complexity, unfairness and inefficiency that can arise when there are boundaries in tax treatment, the hurdle to deviate from neutrality should be high. At a minimum, neutrality can be seen as a useful benchmark against which to judge a tax system.

## 2.2 Problems with the current system

The current system is not neutral with respect to any of the decisions listed above. The problems that arise include (but are not limited to):

- **Distortions to choices over legal form and type of income.** There are incentives to operate through a business structure rather than employment; to

take compensation in the form of dividends or capital gains rather than salary; and to buy back shares (in a way that qualifies for capital gains tax) rather than pay dividends.

- **Timing distortions and disincentives to reallocate capital.** There are incentives to hold on to existing assets rather than sell them and invest in different ones, and for company owner-managers to shelter funds in the company rather than take/pay them out to invest in another taxed asset.
- **Inconsistent saving and investment incentives.** There are disincentives to save in some forms; incentives to prefer tax-favoured assets (including assets with more generous capital allowances relative to true economic depreciation); a bias towards debt rather than equity finance; and sensitivity of saving/investment incentives to inflation rates.
- **Discouragement of risk-taking.** The government takes a share of upside risks but does not cushion downside risks as much.

We discuss each of these problems in turn below. The list is phrased in terms of distortions to behaviour, but most of those distortions also correspond to inequities between people who are taxed differently and complexities in drawing the distinctions between them. As a result of these non-neutralities, there are lots of difficult boundaries in the tax system. For example, we need complex legal and accounting rules (or subjective and perhaps inconsistent judgements) to determine whether:

- X is really employed (IR35 and employment status test);
- X is income or capital gain (for example, carried interest, stock options, share buy-backs);
- X is income or capital drawdown (for example, annuities outside pension funds);
- X is current or capital expenditure and, if capital, what asset class;
- X is debt or equity (for example, hybrid instruments);
- assets being sold are earliest or latest purchased (FIFO versus LIFO);
- an interest payment is business or personal (for example, qualifying loan interest).

These issues get into the knotty weeds of the tax system; they will be a mystery to most people other than tax practitioners, administrators and taxpayers personally affected by them. But it is in such places that the real complexity of the tax system lies.



The boundary issues serve to highlight the arbitrariness and complexity caused by non-neutralities, and how much simpler the tax system could be if such distinctions did not matter for tax purposes. But the problems that arise as a result of non-neutralities are certainly not confined to boundary cases. Even away from the difficult boundary cases, the fundamental unfairness of differential treatment and the economic inefficiency caused by distorting behaviour still apply.

In what follows, we discuss a selection of the problems that are most acute in the small business area. Some of these are live and controversial policy issues – such as the boundary between employment and self-employment and the operation of so-called IR35 rules.<sup>6</sup> Others are settled practice and rarely engender much complaint. But even in those cases, we should not be blind to the complexities, inequities and distortions that are built into the system and largely taken for granted. It is possible to do better.

### Distortions to choices over legal form and type of income

The most obvious way in which our taxes are non-neutral is with respect to legal form – there is a large tax advantage attached to work that happens through self-employment or an owner-managed company relative to employment. There are also strong incentives for those working through their own company to take most income in the form of dividends or capital gains, rather than as salary.<sup>7</sup>

Table 2.1 shows how different sources of income are subject to different taxes and Table 2.2 sets out the thresholds at which different taxes start to be due and the marginal tax rates. Figure 2.1 shows the overall marginal rates applied to different types of income, accounting for all levels of taxation (i.e. the rates for employment and self-employment incorporate National Insurance contributions (NICs) and the rates for dividends and capital gains incorporate corporation tax).

<sup>6</sup> The problems with creating tax boundaries between employees and the self-employed have long been noted. See, for example, Freedman and Chamberlain (1997) and Freedman (2001 and 2003).

<sup>7</sup> Throughout this subsection, we assume that employees are paid regular wages, and not remunerated in other forms, such as employer pension contributions, stock options or benefits in kind, which are taxed differently.

Table 2.1. Differences in tax regimes across legal forms

Employee	Self-employed	Company owner-manager
Income tax charged on salary (above personal allowance).	Income tax charged on profits (above personal allowance).	Income tax and employee and employer NICs on salary as for employees, taken out of company's pre-tax profit.
Employee NICs charged on salary (above primary threshold).	Self-employed NICs (Class 4) charged on business profits (above lower profits limit) at a rate lower than employee NICs. Small flat rate per week (Class 2). No equivalent of employer NICs.	Qualifies for employment allowance if employs someone (other than a single director).
Employer NICs paid by employer at a flat rate on all employees' salaries (above secondary threshold). Employment allowance reduces liability by £4,000 for each employer (assuming a director is not the sole employee).	Capital gains tax (above annual exempt amount) on the disposal of business assets, at a reduced rate if qualifying for BAD relief.	Corporation tax on company profits (after salary deducted), including capital gains on disposal of company assets.
		Income tax on dividends (distributed out of post-corporation-tax profits) above dividend allowance.
		Capital gains tax (above annual allowance) on sale of shares, at reduced rate if qualifying for BAD relief.

Note: BAD stands for business asset disposal.

Table 2.2. Statutory allowances and tax rates, 2020–21

	Starting threshold	Basic rate	Higher rate	Additional rate
Employer NICs	£8,788	13.8%	13.8%	13.8%
Employee NICs	£9,500	12%	2%	2%
Self-employed NICs	£9,500	9%	2%	2%
Income tax on earnings	£12,500	20%	40%	45%
Income tax on dividends	£2,000	7.5%	32.5%	38.1%
Capital gains tax (CGT)	£12,300	10%	20%	20%
CGT with BAD relief	£12,300	10%	10%	10%
Corporation tax	£0	19%	19%	19%

Note: Income tax rates are different in Scotland. The income tax personal allowance is reduced by 50 pence for every £1 of income above £100,000, taking it to zero for those with incomes above £125,000. Employer and employee NICs thresholds depend on pay period; figures shown are annual. Self-employed NICs here relate to Class 4 contributions. Starting threshold for dividends (the dividend allowance) is in addition to the income tax personal allowance, and is really a nil-rate band rather than an allowance. Capital gains tax rates are for personal assets other than residential property and carried interest. BAD stands for business asset disposal. When calculating which income falls within which band, capital gains are treated as the top slice of income, followed by dividends, then savings (not shown), then other income.

Figure 2.1. Overall marginal tax rates, by income type, 2020–21



Note: Tax rates on employment and self-employment are inclusive of all NICs; tax rates on dividends and capital gains are inclusive of corporation tax. Excludes trading allowance and employment allowance where applicable. BAD stands for business asset disposal.

The key distortions – which have been in place for many years<sup>8</sup> – arise because:

- **Self-employed NICs are lower than employee NICs and, more importantly, there is no equivalent of employer NICs for the self-employed.**

Employer NICs are, and should be seen as, a tax on employment. To the extent that employers face the cost of employer NICs, they will be less attracted to employing people. The market may well adjust such that the going wage for employees falls in response to employer NICs, making employment less attractive to employees. But regardless of how the labour market adjusts, employer NICs act to disincentivise employment in a way that they do not disincentivise self-employment. Lower rates of NICs cannot be accounted for by self-employed individuals' lower benefit entitlements (see Box 2.1) or as a means to offset a lack of employment rights. Employment rights may deter employers from using employees but they simultaneously encourage workers to prefer employment over working for their own business. Since employment rights affect both sides of the labour market, they do not represent a bias in

<sup>8</sup> Adam, Miller and Pope (2017) discuss how these tax differentials have changed over the past 20 years.

favour of the employed legal form and there is, therefore, no bias for the tax system to try to offset (see Freedman and Miller (2020) and references therein).<sup>9</sup>

- **Company owner-managers can reduce their tax liability by recharacterising labour returns as capital returns.**

Company owner-managers can pay themselves in either dividends or capital gains, which are typically more lightly taxed than salary.<sup>10</sup> Capital gains on owner-managers' shares in their companies are eligible for a preferential 10% tax rate under business asset disposal (BAD) relief (formerly entrepreneurs' relief), subject to a lifetime limit which has changed many times.<sup>11</sup>

It can be seen from Figure 2.1 that the tax rate differentials between different forms of income vary with the overall level of income. **In the basic-rate band, dividends are the lowest-taxed form of income; above the higher-rate threshold, there is a significant tax advantage for capital gains.**

The tax advantages for business owner-managers can be even bigger than Figure 2.1 implies. Relative to employees, owner-managers have more scope to reduce their tax payments by: (i) deducting work-related expenses from their income;<sup>12</sup> (ii) splitting profits among multiple individuals (for example, with a spouse), reducing their collective tax liability since marginal tax rates rise with individual income; (iii) shifting income across years, and in particular taking money out of a company

<sup>9</sup> There may be circumstances in which employment rights discourage employment. Broadly, this occurs when the costs of providing employment rights are greater than the value of the benefits they confer on employees. In such cases, higher taxes on employment reinforce a discouragement created by employment rights. See Miller (2018) for further discussion.

<sup>10</sup> A company owner-manager looking to withdraw income from their company in a way that minimises their tax liability should pay themselves the National Insurance secondary threshold in salary (which implies no tax but does allow rights to be accrued to the single-tier state pension) and take any withdrawal above that in dividends. HMRC tax records show that company owner-managers respond to the incentive to take their income as dividends (Miller, Pope and Smith, 2019).

<sup>11</sup> Citing the results from Miller, Pope and Smith (2019) – discussed below – the March 2020 Budget reduced the lifetime amount of gains eligible for entrepreneurs' relief from £10 million to £1 million and renamed it business asset disposal relief. BAD relief is also available on the sale of an unincorporated business (or part thereof) and is subject to a number of eligibility criteria (with cut-offs that create distortions in their own right): see <https://www.gov.uk/business-asset-disposal-relief>.

<sup>12</sup> The core difference relative to employees is that employees' expenses are only deductible if incurred 'wholly, exclusively and necessarily' in the performance of their duties, while self-employment expenses need only be incurred 'wholly and exclusively' for business purposes. The difference in practical application is bigger than this difference in wording suggests.

in years when they are in a lower tax band; and (iv) (legally) avoiding or (illegally) evading taxes (see Advani (2020) for evidence of this).<sup>13</sup>

There is evidence that people respond to tax incentives. In the case of legal form choices, the tax incentives can affect the decisions of both workers (who will have an incentive to work through a business if it leads to higher post-tax income) and employers (who may find it cheaper – after accounting for taxes – to contract with the self-employed or a company rather than hire employees).

The clearest evidence on the role of tax in shaping legal form choices came when the government introduced a 0% starting rate of corporation tax in the early 2000s; there was a spike in the number of incorporations.<sup>14</sup> This episode was a stark lesson that incorporations should not be conflated with entrepreneurship.<sup>15</sup>

It is not (currently) known exactly how much of the growth in UK business ownership that has been taking place since the 1970s and accelerated since the early 2000s (see Chapter 1) is caused by tax. But, alongside plenty of anecdotes that tax matters, the comparison with other countries provides suggestive evidence that tax has at least been a contributing factor: the growth in self-employment is not common across OECD countries, with most seeing little change (or a reduction) in business ownership since 2000. The only OECD country with a larger rise in self-employment than the UK has been the Netherlands (see Giupponi and Xu (2020)), which also stands out internationally for having lower taxes on business owners (see Milanez and Bratta (2019)). Baker et al (2018) provide some evidence that those OECD countries with bigger tax differences between employees and the self-employed have higher rates of self-employment, although the causal relationship is difficult to assess. Given the scale of the tax differences across legal forms in the UK, it would be extremely surprising if tax (in combination with other factors such as the rise of technologies that allow people to work via online platforms) were not helping to shape the labour market.

<sup>13</sup> There are two features of the system that are less generous for the self-employed. First, if they are willing to tie up the money until age 55, employees (including company owner-managers) get the most favourable tax treatment of all by getting the business to make an employer pension contribution: employer contributions are not subject to NICs, whereas contributions made directly be an employee or self-employed person are. Second, the self-employed are treated less generously by the benefits system than employees (see Box 2.1).

<sup>14</sup> For further discussion, see Crawford and Freedman (2010).

<sup>15</sup> Increasing the number of new businesses was an explicit goal of the starting rate of corporation tax. See Freedman (2006).

**Box 2.1. Lower tax rates for the self-employed not justified by lower benefits**

It is commonly argued that lower NICs rates for the self-employed reflect their reduced entitlements to state benefits. This argument has merit in principle – if the benefits system creates a bias in favour of employment over self-employment, there is a case for an offsetting tax rate differential to level the playing field.<sup>16</sup> But, in practice, the difference in entitlements is far too small to justify the current tax advantages.

There are just two publicly funded ‘contributory’ benefits that employees can access but the self-employed cannot: contribution-based jobseeker’s allowance and statutory maternity / paternity / adoption / shared parental pay. The value of these reduced entitlements is small: we estimate that they would only justify setting the self-employed NIC rate less than 1 percentage point lower than the combined employer and employee rates. That is, the combined rate on employees is 22.7%;<sup>17</sup> differences in benefits would only justify reducing this to around 22% for the self-employed – still more than double the current 9% rate.

The difference in access to contributory benefits was more significant in the past (although still smaller than the tax differences) but has substantially shrunk as benefits have been extended to the self-employed (and as, more broadly, the contributory nature of NICs has been eroded). What was until recently the biggest difference in entitlements – the fact that the self-employed accrued rights to the basic state pension, but not to the earnings-related top-up (state second pension) – was removed in April 2016; now both the self-employed and employees accrue rights to a single-tier pension. Formerly ‘contracted-out’ (of the state second pension) employees must now pay the full rate of NICs in return for this entitlement, while the self-employed have seen an increase in entitlement with no such increase in their NICs rate. HMRC (2019) estimates that this reform increased the aggregate tax advantage of self-employment relative to employment by about £2 billion.

<sup>16</sup> In so far as any tax and benefit policies have the net effect of favouring one legal form over another, there is a similar case for offsetting it through differential tax rates to level the playing field. This applies, for example, to the rules that allow more generous deductibility of work-related expenses for the self-employed than for employees, and to tax-advantaged forms of remuneration, such as redundancy pay, that are only available to employees. Of course, the prior question is whether some legal forms should be favoured in the first place. As far as possible, it would be better to apply the same benefit entitlement rules, expense deductibility rules, etc. across different legal forms than to offset such differences with differential tax rates.

<sup>17</sup> This is appropriately measured as the total marginal tax rate on an additional £1 paid out by the employer, not on an additional £1 of nominal salary: that is,  $(0.12 + 0.138) \div 1.138$ .

The most significant disadvantage now faced by the self-employed in the benefits system comes from universal credit, which treats the self-employed as earning at least a certain amount (after a year's grace period) even if they report earning less than that and gives them correspondingly less support. This reduction in entitlements was forecast to save the exchequer £1 billion a year by 2023–24 (Office for Budget Responsibility, 2018, table 4.28): a substantial amount, but still nowhere near big enough to justify the £5.9 billion NICs advantage of self-employment. At most, the lower universal credit entitlement might justify a self-employed NICs rate about 3 percentage points lower than the combined employee rate.<sup>18</sup> Yet in any case the argument is (so far, at least) not made as often in respect of universal credit, perhaps because, rightly or wrongly, universal credit is not seen as part of a 'contributory' system in the same way as some other benefits.

Even this difference in universal credit entitlements has been put into question by the COVID-19 crisis. In Spring 2020, the practice of assuming a minimum income for the self-employed was suspended, so at the time of writing the self-employed are treated in the same way as other universal credit claimants. The policy was controversial even before the crisis, so there must be at least a chance that it will not be reinstated in quite the same form after the crisis.

The response to COVID-19 also demonstrated that the government provides broadly comparable income protection for employees and the self-employed in hitherto-unseen ways. The Self-Employment Income Support Scheme (SEISS), which provided grants to the self-employed whose profits were reduced by the COVID-19 crisis, was designed to provide government support that was comparable to that provided to employees through the Coronavirus Job Retention Scheme (CJRS) (see Adam, Miller and Waters (2020)). The crisis showed that not only are standard state benefits almost as generous to the self-employed as to employees, but the unspoken promise of emergency support the government provides to the self-employed is comparable to that for employees. There were, however, people who fell through the gaps of both of the schemes, including company owner-managers who paid themselves mainly through dividends. We return to discuss the implication of this for future policy in Chapter 6.

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<sup>18</sup> Even this is questionable. While the self-employed are subject to the minimum income floor, they are not subject to the work-search requirements that low-paid employees are; to some extent, these can be seen as substitutes for each other (see, for example, Bourquin and Waters (2020)), and it is not clear which is more advantageous. Moreover, those moving from benefits into self-employment are eligible for grants of up to £1,274 (and other support) through the New Enterprise Allowance, whereas those moving into employment are not.



It is common for the rapid rise in business ownership to be held up as a success story (for example, in the UK's 2017 Industrial Strategy; see HM Government (2017)) or at least to be viewed as innocuous. But more business ownership can be a bad thing. The UK has a long tail of low-productivity businesses (Andrews, Criscuolo and Gal, 2016) and we know that self-employment results in very low incomes for most people (Cribb, Miller and Pope, 2019). These findings do not prove that working through a business necessarily *causes* low productivity or income; and even a causal relationship would not necessarily make working through a business a bad thing: Cribb and Xu (2020) find that those moving into self-employment (with no employees) see a rise in self-reported well-being despite lower income. But it should at least give us pause for thought. Providing tax incentives that encourage forms of work that on average are less productive and more precarious than (higher-taxed) alternatives is not necessarily good for individuals or for the efficiency of the economy. Leaving people to make the decisions they think best for themselves is surely the right starting point.

There is also clear evidence that tax incentives affect how company owner-managers take income out of their companies. Miller, Pope and Smith (2019) use HMRC tax records to show that most company owner-managers pay themselves a small salary and take most of their income in dividends or capital gains. Many owner-managers change the timing of payouts to reduce tax liabilities. In the next subsection, we discuss the efficiency loss that can arise when tax affects the timing of income.

**Government revenues are reduced substantially as a result of providing reduced tax rates for business owners**, relative to the tax that would be levied if they were employees. The COVID-19 crisis will have changed the magnitude of these costs as a result, for example, of changes in employment and income levels. At the time of writing, it is not clear how the economy will recover and therefore how the revenue costs of various tax breaks will be impacted. Based on official statistics (from before the COVID-19 crisis and some recent policy reforms), we estimate that the revenue lost through lower tax rates on income from business was around £15 billion per year.<sup>19</sup> Of course, this revenue cost to the government has a corresponding £15 billion gain to the taxpayers who benefit from this largesse. However, the tax advantage is worth less to taxpayers than the £15 billion of tax

<sup>19</sup> Adam and Miller (2020) set out the details behind this revenue number.

they save, because in order to get it some of them are doing things they would rather not. The distortions to behaviour discussed above are the true cost to society.

### Timing distortions and disincentives to reallocate capital

Deferring or delaying tax payments is valuable to taxpayers; it can be thought of as an interest-free loan from the government to the taxpayer. A delay in a tax payment reduces the effective tax rate.

Capital gains tax (CGT) is levied when an asset that has risen in value is sold ('on realisation') rather than when the rise in value occurs ('on accrual'). If I have an asset that has risen in value, this creates an incentive to hold on to the same asset, rather than selling it (triggering a tax liability) and reinvesting the money in another taxed asset. This disincentive to reallocate capital to a different asset is known as the 'lock-in effect', since it locks people into their existing investments.<sup>20</sup>

In that sense, CGT acts as a tax on transactions (like stamp duties) and leads to misallocation of capital: I will continue to hold on to my existing asset even if someone else could use the asset more productively and I could use my capital more productively elsewhere.

The tax system includes reliefs specifically intended to mitigate the lock-in effect in some cases. Under business asset rollover relief, self-employed people who sell certain types of assets used in their business and use the proceeds to buy another asset for use in their business can defer paying CGT on the original asset until they come to dispose of the replacement asset. This can create neutrality between holding on to a qualifying asset and replacing it with another.<sup>21</sup> However, it does not apply to all assets – for example, to selling or buying shares; and as a result it introduces new distortions between qualifying and non-qualifying assets. A second, similar relief to mitigate the lock-in effect in some cases is reinvestment relief,

<sup>20</sup> Note that the existence of CGT on realisation does not create an incentive to hold on to an existing asset if the alternative is to consume the proceeds of sale (or reinvest them in a tax-free form such as an ISA). *Relative to taxing gains on accrual*, CGT on realisation does create such an incentive; but this 'incentive' to delay spending is merely a reduction in the disincentive to save that would be associated with levying CGT on accrual. Relative to a world without any tax distortions, CGT on realisation still encourages me to spend my money rather than hold on to a taxed asset. It is switching from one taxed asset to another that CGT on realisation discourages.

<sup>21</sup> If the asset being bought has a lifespan of 60 years or less, the deferral only lasts for 10 years or until the asset stops being used for the business, whichever is sooner. For more details, see <https://www.gov.uk/government/publications/business-asset-roll-over-relief-hs290-self-assessment-helpsheet/business-asset-roll-over-relief-2020-hs290>.

under which CGT on any asset can be deferred if the seller reinvests the gain through an Enterprise Investment Scheme or social investment tax relief up to three years after (or one year before) selling the asset.<sup>22</sup> Again, this is clearly limited in scope and brings its own problems.

The lock-in effect of taxing capital gains on realisation is exacerbated by the fact that capital gains unrealised when someone dies are not taxed at all: the deceased's estate is not liable for CGT on any increase in the asset's value prior to death, and those inheriting the assets are deemed (for future CGT purposes) to acquire them for their market value at the time of death. This creates a big incentive to hold on to assets that have risen in value and bequeath them – even if it would be more profitable to sell them and use the proceeds in some other way before death (at which point other assets, including the proceeds from the sale of the original assets, could be passed on instead) and even if it would be preferable to pass on the assets (or the proceeds from selling them) immediately.

Disincentives to switch investments, and resulting distortions to asset allocation, do not only apply to selling assets and triggering a CGT liability. Particularly for company owner-managers, the fact that dividend tax is levied only when profits are paid out of a company creates an incentive to shelter money within the company rather than pay it out and reinvest in another taxable asset.<sup>23</sup>

Such lock-in effects arise even when the owner faces a constant tax rate. But there is an additional incentive to keep money in a company when doing so allows the owner to access lower tax rates. Miller, Pope and Smith (2019) use UK tax records to study the income-shifting of company owner-managers. They show that many owner-managers take income out of their company (usually in the form of dividends) that is exactly equal to the higher-rate income tax threshold (currently £50,000). Those with income that fluctuates from year to year around the higher-rate threshold strategically retain or withdraw income from the company depending

<sup>22</sup> If gains are reinvested through a Seed Enterprise Investment Scheme, there is no deferral but 50% of the gain is written off completely. These are in addition to other tax breaks for venture capital schemes: see <https://www.gov.uk/guidance/venture-capital-schemes-tax-relief-for-investors> for an introduction.

<sup>23</sup> Again, this is an incentive to shelter money within the company if the alternative is to switch to another taxed asset, not if the alternative is to take a dividend and spend the money (or move it to an untaxed vehicle such as an ISA). If I face the same tax rate on dividends whenever I receive them, the tax system is neutral towards when I take dividends out to spend.

on whether their income is above or below the threshold.<sup>24</sup> And many owner-managers retain income in the company for longer periods in order to access lower tax rates. They can do this either by taking dividends out of a company at a later date, if that allows them to be taxed in a lower bracket, or by withdrawing money in the form of capital gains, which, subject to lifetime limits, would be eligible for BAD relief and taxed at only 10%.<sup>25</sup> The tax savings can be substantial. For example, among owner-managers claiming (what was then) entrepreneurs' relief in 2015, average capital gains were £500,000. This delivers a tax saving of £75,000 relative to if the income had been taxed at 25% (the effective higher rate of tax on dividends in 2015) rather than 10%.<sup>26</sup>

The incentive for owner-managers to retain earnings in the company in order to access lower tax rates has both positive and negative consequences.

- It creates efficiency losses by distorting business owners' consumption – that is, owners end up spending their money later than they would absent the tax incentives.<sup>27</sup> On the other hand, it reduces distortions to the timing of work. If I could not shield earnings from tax by retaining profits in the company, I would be more likely to turn down additional work in years when my income was above the higher-rate threshold than in years when it was lower; and I might be discouraged from choosing an occupation with volatile earnings in the first place. If I can simply retain the extra earnings in my company until I am in a

<sup>24</sup> Consider an individual who has an annual income around the higher-rate income tax threshold but in some years earns a little more and in some years a little less. She can avoid paying higher-rate income tax if she retains earnings in the company in a year when she earns more than the threshold and she pays them out in a year when she earns less.

<sup>25</sup> Retained earnings boost the value of a company, such that when a company owner-manager sells or liquidates their company, the retained earnings are taxed as capital gains. It is usually impractical for company owner-managers to sell shares a bit at a time in order to extract money gradually in a way that qualifies for BAD relief.

<sup>26</sup> Note that this will typically reflect gains built up over the lifetime of a company and realised in a single year, so the tax saving will be a one-off for that person, not an annual saving. The Office of Tax Simplification (2020, para. 1.18) reports that 72% of taxpayers who reported capital gains in the 11 years from 2007–08 to 2017–18 did so in only one of those years.

<sup>27</sup> An incentive to retain earnings within a company will lead owner-managers to delay their consumption only to the extent that they cannot finance their desired (i.e. undistorted) consumption pattern in other ways, such as drawing on savings or borrowing, until they come to take the money out of their company at the tax-favoured time. But Miller, Pope and Smith (2019) find that owner-managers do not retain as much in the company as would minimise tax – they do not make maximum use of BAD relief, for example – suggesting that they do need some money from their company to finance their current consumption: they cannot do so entirely from other sources, so the incentive to retain earnings will have real effects on their consumption patterns.

lower tax band, I can smooth my taxable income and avoid paying higher-rate tax without needing to change my underlying work patterns.

- People retaining profits in a company until they are in a lower tax band can lead to greater fairness between those with stable and variable incomes. An annually assessed tax with graduated rates penalises people whose incomes vary from year to year. Ideally, we would tax people on their average annual income (or their lifetime income); allowing people to smooth their taxable income across years brings us closer to that, reducing the penalty for those with variable incomes. On the other hand, if the opportunity to smooth taxable income is available only to those who can retain earnings in a company, it is unfair on those with variable incomes who cannot do so – not just employees, but also those business owners who cannot afford to delay taking income out of their company.<sup>28</sup> And note that while retaining profits until I am in a lower tax band is merely smoothing my taxable income over time, retaining profits in order to access BAD relief is not, and does not bring us any closer to taxing average lifetime income. It is hard to see any basis on which it is fair to provide business owner-managers with preferential tax rates through BAD relief.
- Whatever the upsides and downsides of people being able to take their income in a later year when they will face a lower tax rate, the fact that they must keep the earnings in the company in order to do so potentially distorts the allocation of capital, encouraging them to keep investing in that company rather than elsewhere. Indeed, politicians often justify favourable CGT rates as a means to boost investment. However, profits retained in the company do not have to be used to expand the business: they can be deposited in the bank, used to buy shares in other companies, etc., much as they could be if paid out to the owner (albeit without quite as much flexibility as if the money were in the owner's hands directly). Miller, Pope and Smith (2019) find no evidence that tax-motivated earnings retention affects investment within the company: the retained earnings are kept as cash or other liquid assets, not used to buy assets for use in the business. So, in that respect, the tax incentive is not increasing the activity policymakers think they are targeting, but nor is it leading to any great misallocation of capital.

<sup>28</sup> Retaining earnings in a company is not the only way people can smooth their taxable income over time: another is to contribute to a pension, which in effect defers tax on the earnings contributed until they are taken from the pension in retirement. One response to the limited and uneven opportunities for tax-base smoothing is to make such opportunities available as widely as possible. In Section 5.2, we discuss an option that moves in that direction (package 7).

## Inconsistent saving and investment incentives

The effect of tax on investment incentives varies according to the asset being purchased, the source of finance, the investment horizon, the rate of inflation, and the combination of legal forms and vehicles involved. Some investments go untaxed, some are discouraged, and others are subsidised. These differences create distortions between different types of investment.

Start with business taxation, and assume initially that there is no inflation. The key elements of the tax base that dictate investment incentives for companies and the self-employed are:

- Capital allowances, which dictate how quickly the purchase cost of assets can be deducted from revenues in the calculation of taxable profits. Most plant and machinery investments by small businesses qualify for the annual investment allowance (AIA), which allows the full purchase cost to be deducted immediately. The limit on the amount that can be deducted under the AIA is currently temporarily £1 million.<sup>29</sup> For investments that fall outside the scope of the AIA, capital allowances vary according to the type of asset. For example, for most plant and machinery outside the AIA, businesses can deduct 18% of the not-yet-deducted cost each year. Capital allowances may be claimed in the year that they accrue, carried forward to set against future profits or carried back for up to three years.
- Interest payments on loans taken out for business purposes can be deducted from revenues when calculating taxable profits. There is no equivalent deduction for the cost of equity finance (that is, the minimum return shareholders require to persuade them to provide equity capital).

The effects of tax on investment incentives can most easily be seen by considering a marginal investment – that is, an investment that generates just enough revenue to cover the costs (including the cost of debt or equity finance). An efficient tax system would not tax such projects: tax would make such investments unviable, and worthwhile projects would not happen. In contrast, taxing profits in excess of what is needed to compensate providers of finance does not discourage investment

<sup>29</sup> The AIA limit has changed many times in the past decade. See <https://www.gov.uk/capital-allowances/annual-investment-allowance>.

Table 2.3. Worked examples: inconsistent investment incentives

	Year 1	Year 2	
Investment	1,000	0	
Asset value	1,000	900	
Income from asset use	0	150	
Receipt from asset sale	0	900	
		<b>When financed by:</b>	
		<b>debt</b>	<b>equity</b>
Repayment of debt	0	1,000	0
Interest payment	0	50	0
<b>Tax treatment if capital allowances = true economic depreciation</b>			
Taxable income	0	150	150
Capital allowances	0	100	100
Interest deduction	0	50	0
<i>Taxable profit (Income – Deductions)</i>	0	0	50
Tax payment (20% tax rate)	0	0	10
<b>Tax treatment if annual investment allowance</b>			
Taxable income	0	150	150
Capital allowances	1,000	–900	–900
Interest deduction	0	50	0
<i>Taxable profit (Income – Deductions)</i>	–1,000	1,000	1,050
Tax payment (20% tax rate)	–200	200	210
NPV of tax in years 1 & 2		–9.5	0

Note: The net present value (NPV) of tax is the tax payment in year 1 plus the discounted tax payment in year 2. For example, for the debt-financed investment, this is  $-200 + 200/1.05 = -9.5$ . This assumes that the £200 deduction can be used in year 1 (i.e. to offset other tax liabilities). The yellow/red/green shading denotes tax treatment that is neutral / is distortionary / provides a subsidy.

because an investment that is profitable before tax will remain profitable after tax (as long as the tax rate is less than 100%).<sup>30</sup>

Consider the following example, shown in Table 2.3: in year 1, £1,000 is invested in a fixed asset – a machine, say. After one year of use, the asset depreciates by 10% (the value of the asset falls from £1,000 to £900). In the year after purchase (year 2), use of the asset returns an income of £150 and the asset is sold for £900.

If investors require a 5% return on their money, then in the absence of tax this is a marginal investment. The total return in year 2 (including income from both the use and the sale of the asset) is £1,050 – enough to cover the £1,000 cost of the investment plus an additional £50 (5%) profit to compensate the investor for waiting.

How does tax affect our example? Consider first an investment that is financed by debt and assume that in year 2 there is a repayment of the initial loan (of £1,000) and of £50 of interest. If we assume that capital allowances are exactly equal to true economic depreciation then, in year 2, they will generate a tax deduction of £100. Taxable income of £150 from using the asset will be matched by the capital allowance of £100 and debt interest deduction of £50, so total taxable profit will be zero. In this case, the marginal investment is untaxed.

However, in practice, capital allowances are set at one level for very broad asset classes and will rarely equal true economic depreciation. If capital allowances are less generous than economic depreciation, debt-financed investment is discouraged (taxable income would be positive in year 2). More commonly, capital allowances are more generous than economic depreciation, such that debt-financed investments are subsidised. This can be seen in the bottom panel of the table. Under the AIA, there is an up-front deduction of £1,000. This creates a ‘tax shield’ of £200 against tax on other income (we assume in these examples that the taxpayer has other income in year 1 against which to set the £1,000 deduction). In year 2, when the asset is sold, the sale price is added to taxable income. This is known as a ‘balancing charge’ to capital allowances. In practice, these types of adjustments will vary according to the form of capital allowances that have been used and to how the

<sup>30</sup> If investment is internationally mobile, taxing excess profits (i.e. profits above the required return) can still affect *where* the investment happens. We return to this point briefly in Chapter 3, but since we are focusing on small businesses in this report, we largely assume business activity is domestic.



sale price of the asset relates to the written-down (for tax purposes) value. But in each case, the idea is straightforward and can be seen as an adjustment to account for the fact that an asset may have received capital allowances that were different from actual depreciation. In this example, a 100% capital allowance has been given but the asset has not 100% depreciated when it comes to be sold (actual depreciation is only £100). The adjustment is effectively reclaiming capital allowances previously given in excess of the true depreciation of the asset; in this case, a £1,000 capital allowance was given but it turned out the asset was still worth £900, so that £900 excess allowance is recouped as a balancing charge. Taxable profit in year 2 is £1,000 ( $= 150 + 900 - 50$ ) and tax due (assuming a tax rate of 20%) is £200. The net present value (NPV) of tax over the two years is -£9.50 (i.e. a tax credit). By subsidising debt-financed investments, the tax system makes it profitable to undertake some commercially unprofitable investments – investments that would lose money in the absence of tax can be worthwhile because of the tax system.

Turning to equity-financed investments (and still considering only business taxation – we turn to shareholder taxes below), there is a disincentive to invest when capital allowances are equal to true economic depreciation, because there is no deduction for the implicit cost of equity finance. The distortion increases if capital allowances are lower. But when investment is subject to the AIA, there is a ‘tax shield’ of £200 in year 1 and a tax payment of £210 in year 2. The discounted value of the latter (i.e. the value when it is considered in year 1) is £200. As such, the NPV of the tax due is zero. Effectively, the benefit of getting the 100% deduction up front exactly offsets the cost of the future tax payment.

This discussion shows that there is an important apparent tension in the current tax base. If capital allowances are set to approximate true economic depreciation, there will be a discouragement to equity-financed investments. If 100% first-year allowances are given, there is neutral treatment of equity finance at the business level, but a large subsidy to debt-financed investments. The UK has chosen a compromise. For small businesses, most investment is subject to the AIA. This implies that there is no distortion to equity-financed investment undertaken by the self-employed or – in some cases – by company owner-managers using retained earnings. But there continues to be an important disincentive to invest in assets not covered by the AIA and to inject new equity into a company (because normal returns are taxed at the personal level) and a large subsidy to debt-financed

investments. Taxes are not simply distorting the scale of investment, but also adding a range of distortions across assets, financing and forms of ownership and thereby affecting the types of investments that take place.

Inflation exacerbates the problems. Capital allowance schedules generally operate with reference to the historic cost for which assets were purchased, implying that the real value of capital allowances will be eroded by inflation. Even quite modest annual inflation rates can have a significant effect in reducing the real value of these tax allowances below the actual depreciation costs borne by firms, particularly for assets with long lifetimes. For equity-financed investment, this can imply a substantial effect of inflation in raising the cost of capital if capital allowances offer anything less than full up-front deduction. For debt-financed investment, this effect is mitigated by the fact that nominal rather than real interest payments on outstanding debt can be deducted against taxable profits. Per se, this reduces the real after-tax cost of borrowing. Higher inflation may also have other effects – for example, raising the cost of holding inventories that appreciate in nominal value, and increasing the taxation of real capital gains. Even if we thought there might be good reasons why the corporate income tax should encourage firms to use debt and discourage firms from investing, it is unclear why we would want these effects to vary with the rate of inflation.

For the equity-financed investments in companies, incentives are also affected by what happens at the personal level. We must consider the incentive for owner-managers or external investors to put their money into the company; the return that investors require to supply their capital will depend on the personal tax treatment of the return. The key difference relative to unincorporated businesses is not simply that there are two layers of tax but that for the self-employed deductions are against total tax whereas for equity investors in companies (including for company owner-managers) deductions from profits are made against corporation tax but not against personal taxes. An investment that attracts zero net tax at the business level will remain untaxed for the self-employed but might still be taxed for the corporate investor when the shareholder takes money out of the company. And distortions at the company level can be increased at the personal level.

The tax rate on dividends (assuming it is constant) should not affect the incentive for firms to pay dividends now compared with keeping the money in the company, earning a return on it and then paying dividends later. Paying tax now on the money

is worth the same as paying tax next year on the money plus the return earned in the meantime. Consequently, dividend taxation should not discourage investment financed from retained earnings.

But dividend taxation can affect the incentive to inject new equity into a business; and CGT can discourage investment too. The extent to which they affect incentives varies widely. As at the corporate level, the effective tax rate varies with inflation. Furthermore, effective tax rates are lower for those investing over a longer horizon, because of the lock-in effect described above and because the fact that capital gains unrealised at death are written off massively reduces the effective tax rate for those willing to wait that long. And even the statutory tax rates that apply to shareholders' returns vary widely at present, not only because the headline tax rates shown in Table 2.2 differ between dividends and capital gains, but also because of the range of special schemes offering different tax rates in different circumstances:

- As we have discussed, BAD relief provides a reduced (10%) CGT rate for investment by an owner-manager, up to a limit.
- Investors' relief similarly provides a 10% CGT rate for external investors in unlisted trading companies if they hold the shares for at least three years.<sup>31</sup>
- Four different venture capital schemes – the Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS), social investment tax relief (SITR) and Venture Capital Trusts (VCTs) – provide various combinations of income tax relief for amounts invested, CGT relief on returns and other tax advantages for investments that meet qualifying conditions.<sup>32</sup>
- Similarly, several different employee share schemes (enterprise management initiative, company share option plan, save-as-you-earn options, share incentive plans and employee ownership trusts) offer a variety of different tax advantages for shares or share options granted to company employees in different forms.<sup>33</sup>

The variety of different tax rates and regimes applying in different circumstances is bewildering. And that is just considering the tax on shareholdings themselves. If a potential investor is considering not only whether to invest in a company rather than spend the money but also whether to invest in a company rather than save in some

<sup>31</sup> See <https://www.gov.uk/government/publications/investors-relief-2020-hs308/hs308-investors-relief-2020> for details.

<sup>32</sup> See <https://www.gov.uk/guidance/venture-capital-schemes-tax-relief-for-investors>.

<sup>33</sup> See <https://www.gov.uk/government/statistics/employee-share-schemes-statistics-background>.

other form, then the tax treatment of alternative saving options – bank accounts, ISAs, pensions, owner-occupied housing, buy-to-let housing, and so on, each with their own tax regime – is also relevant.<sup>34</sup> Facing (say) 20% tax on returns to investing in a small business might be somewhat discouraging if the alternative is to spend my money or save it in an ISA instead, but might look like a bargain if the alternative is paying 40% tax on interest from a bank account. So for a company owner-manager considering whether to invest more of their own money in their company or to use debt finance instead, the attractiveness of using debt versus equity will depend not only on the corporate tax treatment and on the personal tax they might pay on any dividends and capital gains; they must also consider what else they might do with their money if they do not inject it into the company, and how that would be taxed.<sup>35</sup> For the most part in this report, we will consider shareholder taxation but ignore any tax on alternative savings, which is perhaps not a bad approximation given that pensions, owner-occupied housing, ISAs and the personal savings allowance make the large majority of personal savings tax-free.

But the reality is that the tax system at both personal and corporate levels creates a mess of inconsistent tax incentives for saving and investment in different assets, with different sources of finance and through different legal vehicles.

In Chapter 3, we explain how it is possible to escape the tensions within the current system and design a tax base that is more neutral with regard to all forms of investment.

## Discouragement of risk-taking

Much discussion of the effect of tax on risk-taking focuses on the rate of tax on successful projects – higher taxes on profits or gains (at the corporate and/or personal level) reduce the rewards to success. But what matters when considering risky projects – that is, projects where the outcome is uncertain – is the treatment of good outcomes relative to bad ones. Risk-taking is discouraged by the tax system

<sup>34</sup> Adam and Shaw (2016) compare effective tax rates on different forms of saving.

<sup>35</sup> Exactly how far the personal taxation of savings and the corporate taxation of investment can be combined to consider an overall effective tax rate is not fully resolved. For arm's-length investments with internationally integrated capital markets, the two are likely to be largely separate issues, since the required rate of return after corporate taxes but before personal taxes will be fixed on international capital markets. But in our context of domestic micro-businesses – possibly with people investing in their own or connected people's businesses but still borrowing from international banks, for example – it is less clear-cut.

not as a result of the level of tax on income per se, but because of the asymmetric treatment of upside and downside risk. Effectively, the government takes a share in the fruits of success but does not take an equal share in the pain of failure.<sup>36</sup> If the tax system is symmetric, the government effectively takes a stake in any risky project and, as a result, higher taxes (i.e. the government sharing in more of the risk) can even make risky projects more attractive as it provides a form of insurance (Domar and Musgrave, 1944).<sup>37</sup>

The current tax system does not treat profits/gains and losses symmetrically. Losses often cannot be relieved immediately; they can be carried forward to offset in future, but the delay reduces the value of the relief; and sometimes the losses can never be offset at all. As a result, the system discourages risk-taking.

In Sections 3.4 and 5.2, we return to discuss current loss offset provisions and how they could be made more generous (so that the tax system was less asymmetric). The effect of restricted loss offsets is likely to be more important for younger firms, which are less likely to have a past history of positive taxable profits than established ones, and for smaller firms, because less diversified firms are less likely to be able to offset losses on a new investment against positive taxable profits from their other operations.<sup>38</sup>

## Tax rates, interest rates and the severity of problems

In this section, we have highlighted that there are numerous problems with the current tax base, as well as tax rates. We focused on timing distortions and disincentives to reallocate capital, inconsistent saving and investment incentives, and disincentives to take risks.

But in some ways these problems with the tax base are less pressing than in the past, because of the current low interest rates and low tax rates on capital income.

The inefficiencies created by the tax base are smaller when interest rates are low. Many of the tax base problems arise when income is taxed, or costs deducted, at the

<sup>36</sup> Cullen and Gordon (2007) provide empirical evidence that this asymmetry has important effects on the behaviour of entrepreneurs in the US.

<sup>37</sup> If adverse selection in financial markets makes risk-sharing with outside investors difficult, the tax system can effectively provide an alternative way to share; with more risk-sharing available, the risk premium will be lower, and risk-taking should be greater.

<sup>38</sup> For owner-managed firms, an offsetting consideration may be the owner's ability to convert losses into a lower salary, which permits lower tax payments immediately.

‘wrong’ time and there is no adjustment to compensate for this. When interest rates are low, these defects are less severe because the differences in value between payments made at different times are smaller. For example:

- The lock-in effect – the incentive to hold on to an existing asset rather than switch to a different one – is weaker when interest rates are low, because the value of deferring tax on an accrued gain is lower.
- The capital allowance schedule determines how quickly investment costs can be deducted from taxable profits; if interest rates are low, the value of being able to deduct costs sooner rather than later is smaller, so having the ‘wrong’ capital allowance schedule has less effect.
- Giving a deduction for the interest cost of debt finance, but not for the cost of equity finance, matters less when these costs are low anyway.
- Carrying losses forward does not reduce their value as much when interest rates are low.

This is not true of all the problems with the tax base: the problems arising from CGT uplift at death, for example, or where losses cannot be offset at all, are no less serious when interest rates are low. And the problems caused by tax rate differentials across income sources and legal forms are no less severe when interest rates are low.

To the extent that interest rates are expected to remain low in the long term, that might suggest focusing more on the problems that remain severe even with near-zero interest rates, and in particular focusing primarily on tax rate differentials rather than the tax base.

There is a snag with that approach, however. A second reason the problems with the capital tax base seem less pressing at the moment is that tax rates on capital incomes are so low. The tax base obviously matters less when tax rates are low: if tax rates were almost zero, they could not do much damage whatever the base (though, as we argue in Chapter 3, reduced tax rates on capital income are less well targeted than base reform at reducing distortions to investment decisions). If we increased tax rates without reforming the tax base, the problems with the base would become worse. And crucially, the efficiency costs created by a distorted tax base rise more than in proportion to tax rates, because low tax rates only change behaviour when the decision is marginal anyway; higher tax rates discourage not only more activities, but also more valuable activities. This means that even

problems that are seen as small at the moment could become much larger. The problems created by penalising equity finance and subsidising debt finance, by failing to give full relief for losses and by discouraging transactions that would trigger a tax liability would all be worse at higher tax rates.

The problems with the tax base are unfortunate at the moment. But they would become much more seriously damaging if either interest rates or tax rates on capital income were to rise significantly. There is still a good reason, therefore, to look at problems with the tax base as well as differential tax rates. We will address both in Chapter 3.

## 2.3 Reasons to deviate from neutrality

Neutrality – taxing similar activities similarly – is a good rule of thumb and a benchmark to aim at, but it is not always optimal. Below we discuss two possible reasons to depart from neutrality: first, to deliberately try to influence behaviour when markets fail to provide appropriate incentives (particularly for entrepreneurship, in this context); and second, where differences in how different groups behave mean it might not be efficient to tax them in the same way.

### Deviations to correct market failures

Markets are not perfect. Imperfect markets are the norm, and governments intervene widely to try to shape how they operate and improve on the outcomes they would otherwise generate. In principle, the many ways in which markets fail to produce the best possible outcomes lead to multiple possible arguments for government intervention. However, in practice, correcting market failures by deviating from a neutral tax system is fraught with the dangers of complexity, special pleading and unintended consequences, so there should be a high hurdle to justify deviations from neutrality. Deviations from a neutral tax system should proceed if and only if all of the following are true:

- 1 **There is a very clear rationale.** This requires specifying precisely what it is about current market outcomes that is undesirable and why the market is failing to deliver. What do we want more or less of, and why?

- 2 **Tax is the most appropriate policy tool.** The government has many policy tools, including regulation, information provision, competition policy and direct investment. Broadly, taxes are a good tool when the market failure can best be targeted by changing prices or rates of return (for example, by increasing the after-tax return on certain investments).
- 3 **It is possible to design an actual tax policy whose benefits outweigh its costs.**

### Entrepreneurship

Lower rates of tax for business owner-managers are often defended – by politicians and business groups – as a means to encourage some combination of small business, entrepreneurship, investment, growth and risk-taking. The quote provides one example of this.

**‘We do not want high tax rates to deter investment. The lower capital gains tax rates introduced by this clause will make it more attractive for people to invest in companies, helping those companies to access the capital to expand and create jobs.’**

David Gauke, Financial Secretary to the UK Treasury, 2016

To justify preferential treatment of certain types of activity (for example, investments undertaken by small or closely held businesses), it is not sufficient to cite the benefits the activity brings. If there are benefits to those involved, why will the activities not be undertaken without government intervention? What is required is a case for government action based on a clear reason why the market will generate too little of a certain activity. This can occur when an activity creates positive spillover benefits (externalities) to others. For example, some businesses may be particularly innovative, but underinvest relative to the efficient level because part of the return to investment flows to other firms which can learn from the new products or processes.<sup>39</sup> The market may also generate too little of an activity if there are constraints. For example, if there are barriers to entry or

<sup>39</sup> When individuals or companies make decisions, they might not take account of the costs or benefits that their actions have for others; for example, they might not value the lessons that others learn when a new business concept is tried.



obstacles to growth of small businesses, the market can generate too little activity in the small business sector.<sup>40</sup>

While there is a case in principle for encouraging some types of activity, doing so in practice is very difficult as a result of the enormous heterogeneity found within the small business sector (see Cribb, Miller and Pope (2019) for a discussion of the scope of activities within the small business sector). While some businesses are innovative and generate externalities, and others are facing credit constraints that we would like to alleviate, many are in neither category. Tax breaks for business owners are not well targeted at the kinds of activities (for example, innovation) that government policies may sensibly want to promote.

Specifically, across-the-board preferential tax rates for business owners are poorly targeted at market failures in two ways.

First, the incentives apply much more widely than where there is a rationale for government to try to increase the level of activity. As a result, even though lower tax rates may boost some of the activities that have externalities, at the same time they create a series of other unintended side effects (such as tax-motivated incorporation). Aside from the unfairness and revenue loss created, giving tax breaks where they are not justified can create too many businesses and reduce productivity.

Second, for those firms generating externalities or facing credit constraints, lower tax rates will often have little effect on incentives. The benefit of lower tax rates accrues disproportionately to those who make high private returns on their activities; those are likely to be viable even without support. It is much more effective to target activities that are only borderline-viable and their specific critical features (such as investment and finance costs) where tax can make a difference to whether projects go ahead. It is common for policymakers to focus on tax rates when trying to encourage investment and to pay less attention to the tax base. The irony is that if we moved away from a tax system that is often thought of as ‘encouraging’ activities to one that we would describe as neutral (as discussed above), the overall incentives to undertake investment, for example, would improve. If we wanted to go further and incentivise certain types of activity, it

<sup>40</sup> For example, limited information about growth prospects of small firms, combined with high risk of failure, can make it prohibitively expensive for some small firms to raise debt or equity finance for expansion.

would be better to target enhanced investment incentives (for example, through enhanced investment allowances) at specific types of business rather than give preferential tax rates to business income regardless of whether or not the businesses want to invest.

Similar issues arise with respect to risk-taking. It is not at all clear why the government would want to encourage more risks to be taken: if the market does not provide enough of a reward for people to be willing to take a risk, why push them to do so? However, and as discussed above, at the moment the tax system actually discourages risk-taking. Rather than try to use lower tax rates on future profits to encourage risk-taking, it would be better to adjust the tax base – and specifically the treatment of losses – to minimise the discouragement of risk.

It should also be remembered that tax is not the only policy tool. For example, intellectual property rights, loan guarantees or direct funding for particular activities may allow government support to be targeted more efficiently to where there are market failures than tax measures.

### **An argument for lower tax rates when business owners are more responsive to taxes**

Arguably the best argument for taxing the self-employed and company owner-managers at lower rates than employees is that business owner-managers are more responsive to tax than employees (see, for example, Adam et al. (2020)). The more a tax reduces taxable income, the less revenue it will raise and the greater the loss of taxpayer welfare per pound of revenue raised. So it can be efficient to set lower tax rates for more responsive groups.

The self-employed and company owner-managers are more responsive to tax in part because they have more ways to manipulate their incomes to avoid tax and more scope to evade taxes, rather than just because of ‘real’ economic responses such as the amount of effort they put in. The first way to deal with this, therefore, is to reduce the options that the self-employed and company owner-managers have to sidestep paying taxes in full – for example, by taxing capital gains at the same rates as ordinary income. The reforms we discuss in this report would reduce the extent to which the self-employed and company owner-managers can reduce their tax liabilities more easily than employees. They would not, however, entirely eliminate the difference in responsiveness. For example, it would still be the case that

business owner-managers had greater access to tax deductions and were less subject to third-party reporting of their incomes.<sup>41</sup> And they do genuinely have more control over how much work they do and when.

In principle, therefore, the greater responsiveness of business owner-managers could be used to justify some difference in tax rates (although not necessarily the current rate differentials). But any potential efficiency gains that arose as a result of applying lower rates of tax to more responsive groups would have to be weighed against the costs of differentiation, such as the additional complexity and the distortion to people's choice of legal form. There are also clearly equity concerns over a policy of providing lower tax rates to one group at least in part because they can more easily avoid or evade tax.

<sup>41</sup> On the importance of third-party reporting, see Kreiner, Leth-Petersen and Skov (2016). Advani (2020) shows that it is important for this group in the UK.

## 3. A better tax policy

In the previous chapter, we set out the problems created by the current tax system, with a focus on those that affect owner-managers of small businesses. The problems arise from the design of the tax base – specifically, the treatment of investment and losses – and the fact that different forms of income are taxed at different rates. In this chapter, we set out how most of these problems could be solved.

### Key findings

- 1 Policymaking has been hampered by a perceived tension in setting capital taxes: aligning capital tax rates with labour taxes is desirable to provide equal treatment and minimise revenue loss, but lower rates are deemed desirable to support investment.
- 2 This tension can be overcome. The tax base can be reformed so that taxes do little to discourage saving and investment. Rates can then be aligned across all forms of income.
- 3 There are large differences in tax rates across forms of income. For example, the marginal tax rate, including all taxes, for basic-rate taxpayers is 40.2% for employment income compared with only 29%, 25% and 27% for self-employment income, dividends and capital gains respectively. Aligning all rates to employment income rates would therefore imply some large tax increases, though tax rates on employment could also be reduced.
- 4 There are broadly two different ways to produce a neutral tax base that does not discourage saving and investment. Each ensures that all investment costs are fully deductible from tax.

- 5 A 'cash-flow' approach would give 100% up-front tax deductions for all saving and investment and tax all incomes when they are received.
- 6 A 'deferred-allowances' approach would provide a stream of annual allowances for the amount invested that is worth as much as a 100% up-front allowance.
- 7 Under the cash-flow approach, there would need to be reform of the tax treatment of borrowing. We could either: keep the current interest deduction but also add a deduction for repayments of principal and tax all amounts borrowed; or modify the interest deduction so that only interest payments in excess of a normal rate of return on the outstanding loan would be deductible. The deferred-allowances approach could achieve equivalent outcomes without changing current rules on debt.
- 8 Either option could be applied at both personal and corporate levels. There are also ways to mix different elements of the two approaches. Either could be implemented in a way that leads to relatively small changes for most small businesses. Both would bring many benefits over the current system, including removing the bias in favour of debt and the disincentive to make equity investments in companies.
- 9 As far as possible, tax relief for losses should be symmetrical to tax on profits/gains, to minimise disincentives for risk-taking. This means removing many current restrictions on loss offsets.

## 3.1 The big-picture solution

Before setting out the specifics of how the tax system could be improved, we sketch out the big-picture solution and how it can overcome a perceived tension that has plagued policymakers and capital taxes policies for decades.

## The perceived tension in setting capital taxes

In the previous chapter, we made the case for a tax system that is neutral along various dimensions (except where there are specific reasons to deviate from neutrality). Two compelling objectives can be drawn from this:

- 1 **‘Tax all income the same’**. This creates neutrality across income sources and legal forms, in the interests of fairness, simplicity, avoiding distortions and minimising avoidance.
- 2 **‘Don’t discourage saving and investment’**. This creates neutrality with respect to when people spend their money and how much investment takes place, and also with respect to different types of saving and investment.

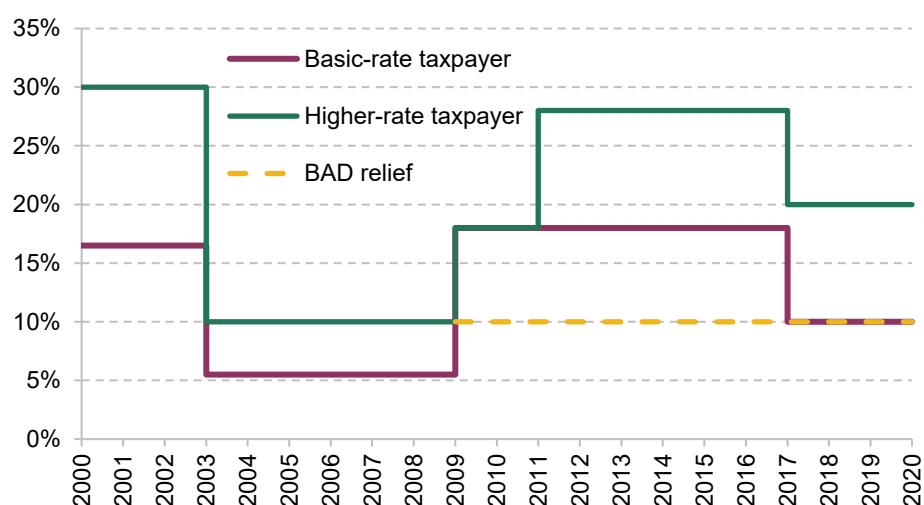
At first glance, there appears to be a conflict between these two objectives, as there so often is between desirable policy objectives. To achieve the first, we would tax capital income (i.e. returns to saving and investment) as much as labour income; to achieve the second, we would not tax capital income at all.

This tension has bedevilled policymakers around the world for decades. The result – in the UK and elsewhere – is typically reduced, but not zero, rates of tax on capital income and gains. But this compromise does not achieve either objective satisfactorily; saving and investment are still discouraged, while there are still opportunities to reduce tax liability by converting labour income to capital returns (as well as all the other problems discussed in Chapter 2).

Not only are lower rates of capital taxes an unsatisfactory compromise; they are also an unstable one. Tax rates tend to yo-yo as the relative emphasis placed on these competing objectives changes. Capital gains tax provides the perfect example of this. CGT rates have been increased and cut, often in different ways for different types of assets or taxpayers, as successive Chancellors battle with the trade-offs between higher and lower capital tax rates described above (see Box 3.1). It would be better to get off this policy roller coaster than continue the ride that successive Chancellors have taken us on.

**Box 3.1. The capital gains tax roller coaster**

There have been many changes to capital gains tax. Figure 3.1 shows how CGT rates have changed for just one type of asset over the past 20 years. Changes to the tax base and over a longer period have been even larger.

**Figure 3.1. Capital gains tax rates**

Note: Rates shown are for a business asset held for two years. Years refer to the start of financial years (e.g. 2000 refers to financial year 2000–01).

Source: [https://www.ifs.org.uk/tools\\_and\\_resources/fiscal\\_facts/](https://www.ifs.org.uk/tools_and_resources/fiscal_facts/).

Capital gains tax was introduced in 1965 at a flat rate of 30%. Geoffrey Howe introduced indexation allowances in 1982, ensuring that only gains in excess of inflation were taxed. In 1988, Nigel Lawson aligned CGT rates with individuals' marginal income tax rates. In 1998, Gordon Brown scrapped indexation allowances for future years and introduced taper relief, which reduced CGT by more the longer an asset was held and was more generous for 'business' than 'non-business' assets. Taper relief was subsequently made more generous, before then being scrapped by Alistair Darling in 2008. Mr Darling announced a return to a single flat rate, set at 18%, but (following a backlash from business lobby groups) introduced entrepreneurs' relief (now BAD relief), which applied a 10% rate to the first £1 million (later increased to £10 million then reduced back to £1 million) of lifetime gains for some business assets. (For further discussion of these reforms, see Adam (2008).) George Osborne raised the rate to 28% for higher-rate taxpayers in 2010, but then cut it (for most assets) to 20% for higher-rate taxpayers and 10% for basic-rate taxpayers in 2016.

## How to set capital taxes to achieve multiple objectives

It is possible to achieve both of the objectives above – i.e. to tax all income at the same rates and to not discourage saving and investment. Indeed, it is possible to achieve neutrality (or get close to it) on all the dimensions listed in Section 2.1. The way to do this was laid out in the IFS-led Mirrlees Review (Mirrlees et al., 2011). We summarise the key idea here and lay out the details below.<sup>42</sup>

The key is to realise that there is more than one policy instrument available to achieve these objectives. We do not have to set tax rates to try to achieve both objectives: we can adjust the tax base as well as tax rates, and with those two instruments it is possible to meet the two objectives.

Specifically, the Mirrlees Review’s recipe for neutrality is:

- 1 Tax income from all sources under the same overall marginal rate schedule.** This is what achieves the objective (1) of taxing all income the same.
- 2 Give full deductions from the tax base for amounts saved and invested.** This is what achieves the objective (2) of not discouraging saving and investment.

In other words, the solution does involve taxing all income the same, but only income over and above deductions for saving and investment.

The design of the tax base is clearly crucial here. To understand what we are trying to achieve with the capital tax base, it is helpful to draw a distinction between ‘normal’ and ‘excess’ returns to capital. The recipe can be rephrased as ‘Don’t tax the normal return to capital, but do tax excess returns in full’.

### Don’t tax the normal return

The ‘normal’ return – which is discussed in more detail in Box 3.2 – is the rate of return available on a risk-free asset, and should be the minimum return that a saver or investor needs to receive in order to be willing to save or invest an extra £1. Saving and investment are discouraged when there is tax on the normal return. If an investment would yield more than the normal return before tax but less than the normal return after tax, the tax will stop the investment taking place because the

<sup>42</sup> Parts of this section draw heavily on the exposition in the Mirrlees Review.



investor will no longer receive a sufficient return. Section 2.2 set out examples showing how taxing the normal return discourages investment.<sup>43</sup>

Taxing the normal return to capital therefore discourages saving and investment. Moreover – and perhaps more importantly – it inevitably discourages saving and investment to an extent that varies both over time and across assets. Many of the problems with the tax base discussed in Section 2.2 are inherent to attempts to tax the normal return to capital. It is virtually impossible to apply a consistent effective tax rate to the normal return to all capital.

To see why, recall that (as we discussed in Section 2.2) the timing of tax payments and deductions matters: they are less valuable if they are delayed. For personal taxation, this particularly affects the taxation of capital gains. If capital gains are taxed on realisation (as they have always been), the effective tax rate on the return is lower the longer the asset is held. This creates an incentive to hold on to assets for longer (the lock-in effect). It creates an incentive for cash income to be converted into capital gains. It favours assets that generate returns in the form of capital gains over assets that generate returns in the form of cash income. And it favours those who retain profits within a company, shielding them from tax.

To avoid these problems and tax returns to capital consistently, a comprehensive income tax would tax capital gains as they accrued, not when they were realised.<sup>44</sup> But taxing capital gains on accrual would be extremely difficult. All assets would need to be ‘marked to market’ or valued in years when they are not traded.<sup>45</sup> That is

<sup>43</sup> Within economics, there is a large body of work on how normal returns should be taxed (Bastani and Waldenstrom (2020) provide a recent review). This is an area of ongoing debate. There are various subtle arguments in favour of taxing normal returns. One is that the observed level of personal saving contains information about earning capacity over and above that contained in labour income, such that taxing savings might be a useful way of redistributing. However, we do not think there is sufficient evidence to show that any benefits from taxing normal returns would outweigh the costs, which would include disincentives to invest and to work and difficulties in maintaining consistent taxation across different forms of saving and investment. See Mirrlees et al. (2011, ch. 13) for discussion.

<sup>44</sup> Auerbach and Bradford (2004) develop a ‘generalized cash-flow tax’ which does achieve a constant effective tax rate on capital based on taxation on realisation rather than accrual. But the formula they propose for adjusting realisation-based taxation to achieve this is rather complicated and, as far as we are aware, has never been seriously considered for implementation in any country.

<sup>45</sup> Another practical difficulty is that taxpayers would be faced with a tax bill in years when they did not have liquid assets with which to pay the tax. This difficulty might be addressed by allowing taxpayers to defer payment for a period, though deferral would have to be with interest (specifically, the normal rate of return) to avoid reintroducing all the problems with taxing gains on realisation.

a daunting challenge in the case of private companies and unincorporated businesses – and also a big ask for many other assets, from housing and other durable goods to defined benefit pensions.<sup>46</sup> Failing to do it accurately for all assets would create a bias towards some assets over others. And if that did not look difficult enough, it becomes virtually impossible when we consider returns to investment in ‘human capital’ – that is, people’s skills and earning capacity. We would presumably not dream of trying to measure and tax changes in the value of people’s human capital directly. Consequently, we would create a bias towards investing in human capital (through training, for example) rather than investing in other forms. But for small businesses, the owner-manager’s human capital might be a big part of what gives the business its value, and capital gains on a business would partly reflect increases in their human capital. If, despite the challenges, we somehow managed to tax owner-managers on rises in the value of their business – which accrued partly because they spent time honing their trade and building customer relations (investing in generating future earnings rather than maximising current earnings) – but we did not also tax employees on the increase in their future earning power from doing (formal or on-the-job) training, that would penalise the self-employed relative to employees and create a tax bias against working through a business: the opposite of the problem we have now. Essentially, we would be taxing the returns to human capital investment for the self-employed (as capital gains on their business) but not for employees.

In the context of business taxation, the same problem of needing to value assets every year appears in a different guise. The challenge of correctly valuing assets means we must give a deduction each year for the depreciation of assets.<sup>47</sup> To tax the normal return to all capital consistently, tax deductions for depreciation (capital allowances) would have to match true economic depreciation rates. But firms invest in many different assets with different useful lives and depreciation rates. It is impossible for legislation to specify a precise depreciation schedule for every asset. As a result, the tax system will favour investment in assets where capital allowances

<sup>46</sup> Valuing assets each year is essentially the same requirement as for implementing an annual wealth tax. The challenge of valuations for a wealth tax was considered by various contributions to the recent Wealth Tax Commission: <https://www.ukwealth.tax/>.

<sup>47</sup> There is more than just a parallel between taxing capital gains on accrual and giving deductions for depreciation: they are in fact the same thing. Depreciation *is* a capital loss – a fall in the value of an asset – so giving allowances each year for true economic depreciation is simply an example of taxing capital gains (or in this case relieving capital losses) as they accrue. See IFS Capital Taxes Group (1991).

exceed true economic depreciation, and penalise investment in assets that capital allowances write off too slowly.

On top of all this is the issue of inflation. Conventional taxes on income and profit discourage saving and investment to an extent that varies arbitrarily over time as inflation rises and falls.<sup>48</sup> To have a constant effective tax rate on the real return to capital, the tax base would need to be indexed for inflation so that only above-inflation returns were taxed. This does not just mean indexing capital gains for inflation, as was done in CGT until 1998 and corporation tax until 2017; it also means taxing only above-inflation interest on bank accounts, restricting deductions for firms' debt finance to real rather than nominal interest payments, and specifying capital allowances in relation to the inflation-adjusted value of assets, rather than their historic purchase price.<sup>49</sup> In principle, all these could be done. In practice, the administrative obstacles are formidable, and only indexation of capital gains has ever been implemented.

As we will see, all these problems can be sidestepped if we do not try to tax the normal return to capital. One way to do this is not to tax *any* returns to capital – as we do with ISAs (at least for personal tax), for example. But we will argue that there are good reasons to tax above-normal returns to capital; and that this can be done consistently without needing to tax capital gains on accrual or make adjustments for inflation.

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### Box 3.2. Key concept: the 'normal' return

The 'normal' return can be defined as the rate of return available on a risk-free asset. In a country such as the UK, where the risk of the government defaulting on its debts is generally considered negligible, it can usually be approximated by the yield on medium-term gilts (though in exceptional circumstances the gilt market has been known to reflect something other than a virtually risk-free rate of return on capital).

Under textbook assumptions, the normal rate of return will also be the minimum return that a saver or investor needs to receive in order to be willing to save or invest an extra £1. If I

<sup>48</sup> Adam and Shaw (2016) show how effective tax rates on saving vary with inflation.

<sup>49</sup> This is not a complete list. Other examples include adjusting for the effect of inflation on the nominal value of firms' inventories; and for debts such as trade credit on which no interest is actually payable, businesses would need to include the fall in the real value of this debt (or, equivalently, the implicit receipt of real interest income) as a taxable profit.

am considering an investment – for example, in my own or someone else’s business – then I will invest only if I expect the investment to return at least as much (after adjusting for risk) as a safe alternative such as a government bond. If the investment offers more, then I will be willing to reduce my savings elsewhere (or borrow) in order to invest. If everyone is making these calculations and capital markets are functioning well, then at the margin (i.e. in considering whether to save an extra £1) everyone will have the same risk-adjusted required return, equal to the normal rate of return.

The required return is, in turn, equal to the rate at which people discount additional future income, which they do because money received in the future (even if received with certainty) is not as valuable as money in their hands today. If I would be equally happy getting £100 this year or getting £105 next year – my ‘discount rate’ is 5% – then I would require a rate of return of at least 5% to persuade me to save £100 now.

So the normal return can be thought of as the return that just compensates savers and investors for the delay in consumption (without any additional compensation for risk-taking), and makes them willing to part with their money.

It might seem surprising that the discount rate, or the required rate of return, should be the same for everyone, despite the fact that people clearly differ in their preferences for current versus future consumption – how patient they are – and in the timing of their income and needs.

The explanation lies in the difference between people’s willingness to save *overall* and their willingness to save an *extra* £1. The former will vary, but (under textbook assumptions) the latter should not.

If the return available is 5%, but I would be willing to sacrifice £100 today for only £103 next year, then I will save the £100, get £105 next year and be better off. But I will not be willing to save *all* my money at a 5% interest rate and starve today. I would need a higher return to persuade me to save an extra £100 this year if I am currently due to have £200 this year and £1,000 next year than if I am due to have £1,000 this year and £200 next year. The more I save, the less willing I become to save even more. So I will adjust my level of saving until the amount I would need to receive next year to persuade me to sacrifice an extra £100 this year is exactly £105.

The same is true for everyone else as well: they will all save just enough that the return that makes them indifferent between additional money now and in future is the normal rate of

return. So differences in people's preferences and circumstances should lead to differences in the total amount they save (or borrow), not in the return they require to save an *extra* £1.

In reality, of course, capital markets do not function as well as the textbook model assumes. Most obviously, people (or firms) that would like to borrow more but are unable to do so might have a much higher discount rate (i.e. value additional money today more, relative to additional money tomorrow). There is additional value in enabling such people/firms to access finance up front, and different tax policies help with that to different extents. But for the most part, treating the normal return as being investors' required rate of return and their discount rate as well as the risk-free rate of return will be a reasonable (albeit not perfect) approximation.

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### Do tax excess returns

Returns to capital will often be higher – and sometimes substantially higher – than the normal return. We will refer to all differences from the normal return as 'excess returns' (negative if an asset yields a below-normal return). Such returns can reflect:

- **Luck** in the outcome of risky investments. Since people generally prefer a safe bet, higher-risk investments will generally only be attractive if they offer a correspondingly higher expected return, or **risk premium**; so those who invest in risky assets can earn above-normal returns on average (not just if they happen to get lucky).
- **Economic rents**, which are a return greater than that required to make an investment worthwhile. Rents generally arise from a factor being in limited supply, whether that is land or another natural resource, government-induced restrictions such as taxi licences, monopoly power, unique ideas, private information or brands (including those related to innovators, artists, sports stars and firms).
- **Effort and skill**. Excess returns to capital can directly reflect returns to effort (for example, where excess returns reflect skill in choosing the best investments or effort that was put into capturing rents) or indirectly reflect returns to work where labour income is being 'disguised' (for example, where a company owner-manager pays herself in dividends or capital gains rather than through a salary).

In practice, capital incomes will often reflect a mix of sources. For example, private pensions – the largest component of UK wealth – will largely reflect labour incomes and normal returns to those incomes (plus a risk premium if, as is common, the pension fund is largely invested in equities). But for some people, pension assets may incorporate significant excess returns, which in turn could result from some people being better at choosing investments and some people getting lucky. Some houses will have amassed large capital gains as a result of being located in an area that became more attractive, while others will have risen in value as a result of renovation. Some business assets will be valuable both because their owners were highly skilled and put a lot of effort into building a business and because the business had a monopoly.

There are strong reasons to tax excess returns. It is economically efficient to tax economic rents at arbitrarily high rates. Rents are pure profits that arise when a resource generates a high return relative to its next-best use. A tax that is only levied on the excess income over the next-best use should not distort behaviour because the taxpayer will still prefer to keep using the resource for the same purpose.<sup>50</sup> It is also desirable to tax excess returns to capital that reflect work done; both fairness and efficiency suggest we should tax such returns at the same rate as regular labour income. A tax on the risk premium will not distort investment decisions as long as downside risks are cushioned as much as upside risks are taxed. In practice, this means that a tax on positive returns to risky investments needs to be accompanied by provisions that allow losses to be offset as freely as possible for tax purposes (see Sections 3.4 and 5.2 for further discussion).

In principle, we might want to set different tax rates on different types of excess return. In practice, this is not possible. Taxing excess returns at labour income tax rates is a good compromise; it is demanded by the third possible source of excess returns set out above and entirely consistent with the first two. This also achieves the first objective that we set out above – to *tax income from all sources under the same overall marginal rate schedule*.

### The problems that would and would not be solved

This proposed solution – to exempt the normal return to capital from tax but to tax all excess returns at the same rates as labour income – offers a significant prize. It

<sup>50</sup> An exception is where the tax base associated with an economic rent can move between countries. In that case, the risk of flight sets a limit to how heavily it is efficient to tax rents.

would deal with most of the problems laid out in Section 2.2, including reducing the incentive to choose legal form for tax reasons, removing the incentive to recharacterise labour income as capital income, and alleviating a range of distortions to investment decisions, including those that arise from the inconsistent treatment of different asset types and different sources of finance, disincentives to reallocate capital, sensitivity to inflation, and the bias against taking risks. Such a system would be fairer and more efficient than the one we have now. It would also mean that any increases in tax rates would not come at the expense of worsening investment incentives.

The solution we propose would also have benefits far beyond the small business sector. The taxation of employees, the self-employed and company owner-managers sits precisely at the point where many parts of the tax system come together. Incentives to switch between legal forms depend on the bases and rates of income tax (including the treatment of dividends), NICs, corporation tax and CGT. Changing any one of these has far-reaching effects: tax rates on earnings affect all employees, not just those who might otherwise set up a business; corporation tax affects all companies, from one-man bands to multinationals; taxation of dividends and capital gains affects portfolio shareholders and buy-to-let landlords as well as business owner-managers.

Our big-picture solution is drawn from the Mirrlees Review, which set out to consider the tax system as a whole. As such, the solution that we put forward does take account of how the proposals would affect the whole of the economy. One big advantage of these proposals is that they can – indeed, should – apply beyond the small business context. That is, they would fix an even wider set of problems than the ones discussed in this report.

This is important: the changes we are suggesting may seem like a sledgehammer to crack a nut if one is focusing on one specific problem such as tax-motivated incorporation, but the real beauty of the approach is that it is not simply fixing one or two specific problems, but a whole raft of them, within the small business sector and beyond it.

Perhaps most notably, the reforms could be applied to (and fix problems associated with the taxation of) the full range of businesses, from sole traders to giant multinationals, with no need for separate regimes or arbitrary boundaries. Many of

the problems with the current system we discuss here – disincentives for equity-financed investment alongside subsidies for debt finance, unequal treatment of different assets, lack of symmetric loss offsets, and so on – are at least as problematic for large companies as for small ones. Essentially the same solution would address the same problems. Applying these reforms to big companies would not merely be an accidental side effect of fixing problems in the micro-business sector, but a major benefit in its own right. Similarly, the alternative model we propose for the personal tax treatment of saving and investment would improve the taxation of landlords, portfolio shareholders, etc. as well as those investing in small businesses.

It is also worth noting that the solution we lay out is as suitable for a modern knowledge economy as it is for a traditional manufacturing one – that is, the approach deals as well with intangibles, ICT and the gig economy as it does with plant & machinery and buildings.

The Mirrlees Review discusses all of these aspects. Our aim in this report is to zoom in on the taxation of small businesses, rather than tackling the whole of the tax system at once. It is possible to make progress on the taxation of small businesses without having to grapple with the whole economy in one go: the smaller example reform packages we set out in Chapter 5 are chosen as options that would alleviate some of the problems with taxing different forms of work and small business without entailing wholesale reform of the taxation of multinationals etc. But it is important to recognise the wider picture of which small business taxation is a part, and the wider benefits the full set of reforms could bring.

The proposed ‘solution’ described in this section would not fully resolve all existing problems with the tax system, however, for several reasons.

First, it might not be possible to implement the solution we propose perfectly. In particular, making relief for losses fully symmetric to the taxation of profits/gains is probably not achievable because of the scope for tax evasion it would risk opening up. We discuss smaller practical steps in that direction in Section 5.2.

Second, problems that would be completely ‘solved’ theoretically might not be in practice. In some cases, neutrality would be perfectly achieved only under assumptions that will not fully hold in reality – for example, that capital markets function efficiently or that future policy is expected to be stable. It is better to think



of the reforms in practice as approximating neutrality – and certainly getting much closer to neutrality than existing policy.

Third, while we address the most important ways in which the tax system favours one legal form over another and distorts investment decisions, we do not address all of them. Some might be dealt with through separate reforms we do not consider in this report; in other cases, the trade-offs are all but inescapable.

- There would still be an incentive and opportunity to **split income from a business** between individuals (typically spouses). The opportunity for tax savings here stems not from different tax treatments of labour income and capital income, but from the combination of independent taxation of couples and a progressive rate structure in the personal tax system. With such a tax system, it is difficult to prevent income-splitting, since it is hard to determine how much of the income from a business should correctly be attributed to each individual.
- Even fully symmetric loss offsets, if they were achievable, would not completely eliminate disincentives for **risk-taking**, because the treatment of losses is not the only disincentive for risk-taking in the system. Another is the presence of graduated rates of tax: someone with income just below the higher-rate threshold, for example, is discouraged from taking a risk because an unexpectedly high return would be taxed at the higher rate whereas an unexpectedly low return would only reduce tax liability at the basic rate. Since we do not propose a single flat tax rate, we cannot eliminate that disincentive.
- There are other policy and administrative differences between the taxation of employees and the self-employed that we do not address in this report, but which could be addressed separately. These include the more generous treatment of **work-related expenses** for the self-employed (including the option of claiming a £1,000 trading allowance instead of deducting any expenses and capital allowances), the availability of certain forms of **tax-favoured remuneration for employees** (such as employer pension contributions, medical check-ups and redundancy payments), and the use of **PAYE versus self-assessment** (the latter bringing cash-flow benefits from paying tax later, but with more hassle).
- The scope for **tax evasion** would continue to be greater for business owner-managers than for employees, because of the lack of third-party reporting of their income.

Finally, there are some fundamental issues in tax policy that can never be fully resolved. These apply much more widely across the tax system but nevertheless touch the small business sector, and are not directly targeted by our proposals but are nevertheless affected by them.

- **Work incentives.** All taxes on economic activity create disincentives to work. Under our full ‘solution’, work incentives would be somewhat strengthened for employees (in so far as tax rate alignment was pursued by reducing taxes on employment), weakened for business owner-managers (in so far as tax rate alignment was pursued by increasing tax rates on income from business), and strengthened for those working to pay for future rather than current consumption (because the penalty for saving would be reduced). The combination of reforms would help to even out work incentives between those currently facing stronger and weaker incentives. But there would be no first-order effect on work incentives on average unless the overall level or progressivity of taxation were changed (which would be consistent with our proposals but is not part of them).
- **International mobility.** We focus in this report on micro-businesses, the vast majority of which operate in a purely domestic context. But international issues will be relevant for some small businesses – and, as noted above, the long-run ideal we describe would apply more widely. In a purely domestic context, the solution we outline – taxing only above-normal returns to capital – would largely remove disincentives to invest. But when firms are choosing whether to invest in the UK or elsewhere, a tax on excess returns can still affect the UK’s attractiveness. Tax rates on workers and shareholders (along with the quality of public services and other factors) also affect how attractive the UK is as a place to live, work and do business. The overall effects of our proposed changes on the UK’s international attractiveness would be positive in some cases and negative in others, depending on which combination of tax rate adjustments were chosen (international competitiveness should be one consideration in that choice). And we do not address the issue of international profit-shifting (and associated tax avoidance) in this report.
- **Distinguishing business costs from consumption expenditure.** This is a pervasive headache for all tax systems, since costs of working or doing business (including investment costs) should be tax-deductible whereas consumption spending should not be, and for many purchases (such as a car, a laptop, a bus pass, childcare or a course of study) the purpose can be difficult to establish and

might be mixed. The proposals in this report would increase the pressure at this boundary in some ways (more generous deductions for investment costs would make it more important to distinguish them from consumption expenditure) and reduce it in others (the tax consequences of distinguishing between personal and business loans would be lessened). But giving full deductions for investment costs would unambiguously reduce the pressure to distinguish investment spending from businesses' current expenses, which are already fully deductible.

So the long-run ideal we describe in this chapter is not a panacea. But it would move a long way in the right direction, and eliminate or greatly reduce a number of the biggest problems in this area of the tax system.

## 3.2 How to align tax rates

There are various ways that tax rates could be changed so that the same overall marginal rate schedule applied to all forms of income – and therefore all legal forms. When considering the rates that apply to employment, one must account not only for income tax but also for employee and employer NICs. Similarly, when considering rates of personal capital taxes, any corporation tax due must also be accounted for. It is only by aligning overall rates – including all layers of tax – that a level playing field can be created. Table 3.1 shows the current (2020–21) overall marginal tax rates on employment, self-employment and dividend income and capital gains (as depicted in Figure 2.1); alignment requires that within the basic-, higher- and additional-rate bands, all of the rates be the same across income sources.

Achieving alignment would require:

- extending full NICs (including employer NICs) or equivalent to all taxable income, including self-employment income and dividend income;<sup>51</sup>
- aligning CGT rates with these (NICs-inclusive) tax rates on income; this includes abolishing BAD relief and removing the uplift of capital gains at death;

<sup>51</sup> Tax rate alignment should take account of Class 2 (flat-rate) as well as Class 4 (earnings-related) NICs paid by the self-employed. The Class 2 rate is very low and, for simplicity, we ignore it in what follows.

**Table 3.1. Illustration of tax rises needed to align all rates with current employment taxes**

	Basic rate	Higher rate	Additional rate
<b>Combined marginal tax rate (2020–21) on:</b>			
Employment income	40.2%	49%	53.4%
Self-employment income	29%	42%	47%
Dividend income	25.1%	45.3%	49.9%
Capital gains – regular <sup>a</sup>	27.1%	36%	36%
Capital gains – BAD relief <sup>a</sup>	27.1%	27.1%	27.1%
<b><i>Illustrative ways to align overall rates with employment income</i></b>			
<i>Increase Class 4 NICs from:</i>	9%	2%	2%
<i>to:</i>	20.2%	9%	8.4%
<i>Increase dividend tax from:</i>	7.5%	32.5%	38.1%
<i>to:</i>	26.2%	37%	42.5%
<i>Increase regular/BAD CGT<sup>a</sup> from:</i>	10%/10%	20%/10%	20%/10%
<i>to:</i>	26.2%	37%	42.5%

<sup>a</sup> The marginal rates on capital gains shown in the top panel are inclusive of corporation tax, and therefore apply only to capital gains on shares. Accordingly, the changes to CGT in the bottom panel would also apply only to capital gains on shares (and affect gains currently qualifying for investors' relief as well as BAD relief).

- applying reduced personal tax rates (relative to full alignment) to dividends and capital gains on shares, reflecting corporation tax already paid;
- removing separate allowances for each income source.

Rates could be aligned at any level in order to remove the distortions we highlighted in Chapter 2. That is, tax rates could be levelled up to current employment tax rates, down to current capital tax rates or set somewhere in between. And there are many combinations of rate changes that could achieve the same outcome. For example, as an alternative to simply raising NICs on non-employment income, income tax rates could be raised and employee or employer NICs rates lowered. We illustrate some of the possibilities in Chapter 5.

To provide a sense of scale, the bottom half of Table 3.1 illustrates how rates of self-employed (Class 4) NICs, dividend tax and capital gains tax would need to change if increases to these rates were used to produce alignment with taxes on employment income. This shows that the largest increases would be to tax rates in the basic-rate band and to the higher rates of CGT; this reflects where the largest tax advantages in the current tax system are. Again, this is just an illustration; rates could be aligned in others ways, and would not necessarily need to be set at current rates of employment tax.

The extent to which tax rates should be aligned by ‘levelling up’ tax rates on income from business versus ‘levelling down’ tax rates on employment simply depends on the government’s overall view on how high it wants taxes (or at least direct taxes) to be.<sup>52</sup>

Where individuals are effectively only generating labour income and taking it in the form of self-employment income, dividends or capital gains, increasing tax rates on those income sources to align them fully with labour income tax rates would represent a large – in some cases, very large – tax increase (felt by them and those using their services). There is no way to effectively equalise the tax treatment of different legal forms without making those groups worse off, although this could equally be described as removing the tax advantages they receive under the current tax system. Increasing tax on the work they do is of course undesirable in itself, but there is no good reason to tax work less heavily if it generates business income than if it generates employment income. Increasing tax on business income while reducing tax on employment income would even out the treatment across legal forms without increasing tax on work overall.

One group about which there would likely be significant concern is the low-income self-employed, including those working in the so-called gig economy. Many in this group are struggling with low incomes and precarious working conditions and have done particularly badly since the 2008 financial crisis and during the COVID-19 crisis. The lowest earners will already be paying little or no tax on their incomes, and we do not propose to change that. But full rate alignment implies higher tax rates on still relatively modest self-employment income. Where people are being pushed into self-employment by firms wanting to avoid paying employer NICs for

<sup>52</sup> An interesting option for achieving closer alignment would be to make more use of indirect taxes: to have lower taxes on employment (without reducing tax rates on income from business) and make up the revenue through higher VAT, which applies to all income sources.

(and providing employment rights to) those who do work for them, increasing their tax rates might seem at best a counterintuitive response and at worst downright perverse. Nevertheless, we think it is the right thing to do. In some cases, the tax rise may be passed on to engagers as self-employed workers increase the amount they charge. If, in the current system, engagers are benefiting from the lower tax rates, we would expect them to bear the cost of increased taxes. In other cases, tax rises would be felt by the workers themselves. But note that in these cases the workers will also be the ones currently benefiting from preferential rates – they will already be charging more for their services than an equivalent employee could command. At any income level, there is no reason for the tax system to favour those working through their own business over employees in that way. Where there is concern about hard-pressed low-paid workers, we should reduce taxes for employees and the self-employed equally, not levy higher taxes on employment that push it out of the reach of many. As argued in the government-commissioned Taylor Review (2017), ‘treating different forms of employment more equally in the tax system would be fairer, more economically efficient and support better quality work’. Of course, the market would take time to respond to tax changes, so there is a case for preannouncing changes and implementing them gradually so that people and firms have time to adjust.

If rate alignment is pursued at least partly by reducing taxes on employment, in purely economic terms it should not matter in the long run whether the cut is to employer or employee NICs: firms care about the total (tax-inclusive) cost of employing someone, and workers care about their after-tax earnings, so the basic laws of supply and demand dictate that nominal wages should adjust over time to leave labour costs, after-tax earnings and employment the same regardless of who is legally liable for the tax. In the short run, it would matter: until wages adjusted to the new tax rates, reducing employee NICs would help workers and encourage people to work, whereas reducing employer NICs would help businesses (more precisely, their owners) and encourage them to hire. In the long run, wages would adjust so that the tax cut achieved the same combination of all of these effects regardless of which tax rate was reduced.<sup>53</sup> But the adjustment to the long run might

<sup>53</sup> See CPB et al. (2015) and Adam, Phillips and Roantree (2019) for discussions of the empirical evidence on this.

take some time, and policymakers might choose partly on the basis of the short-run effects.<sup>54</sup>

In reality, the decision might be based as much on political (mis)perceptions of giving a tax cut ‘for’ employers versus employees. In that regard, cutting taxes for employees might seem the more attractive option. But note that levying an equivalent of employer NICs on self-employment and shareholder income might be the most challenging part of achieving rate alignment. The more employer NICs is reduced, the smaller that challenge. In other words, reducing employer rather than employee NICs rates would give more headroom to increase self-employed NICs before it has to exceed the employee rate in order to achieve alignment.

For corporate-source income, the key formula is that the combined tax rates on company profits and dividends / capital gains on shares should equal tax rates on employment income. So the question is how much to increase shareholder versus corporate tax rates. If the tax base were reformed as we advocate in this chapter (see Section 3.3), then in economic terms it would not matter for purely domestic arrangements. The decision should therefore be based on non-economic and non-domestic criteria – that is, administrative and international considerations (leaving politics aside). Bearing in mind that these tax rate changes would apply to all UK-taxpaying shareholders and companies, not just the small ones we focus on in this report, these considerations include:

- *International mobility of the tax base.* Taxable corporate profits are more mobile than shareholders’ residence, so it is more important for the UK’s corporation tax rate to be internationally competitive than its shareholder tax rates. That is a strong argument for increasing shareholder rather than corporate tax rates.
- *Observability of the tax base.* Historically, it was difficult for the UK government to monitor the income and capital gains that UK-resident individuals made from shares in foreign companies; it largely relied on trusting taxpayers to declare such income. That was a reason to keep the tax rates on shareholders’ income low. However, initiatives in recent years to increase

<sup>54</sup> Again, the transition from short run to long run could be accelerated by announcing the changes some time before they were to come into effect, so people would start to adjust. Such preannouncements are less likely to cause forestalling and other timing-related distortions in the case of NICs rate changes than most other tax changes.

exchange of information between countries have somewhat lessened this concern.

- *Compliance burdens.* Until April 2016, the UK's tax rates on dividends were set such that they were not taxable at the basic rate – significantly reducing the administrative burden of dividend taxation and the number of people needing to go through income tax self-assessment. That is no longer the case, though the dividend allowance (introduced at the same time) still limits the number of people having to pay tax on dividends. If the government wanted basic-rate taxpayers to pay tax on their corporate-source income without having to account for personal tax, it would have to be levied at the level of the company.

If reforms went only part of the way towards the long-run ideal described in this chapter, there would be other considerations. In particular, if the tax base were not fully reformed, then increasing tax rates would exacerbate existing problems with the tax base, and an important question would be which tax base's (remaining) imperfections are least harmful to magnify.

### 3.3 Options for fixing the tax base

To recap, our big-picture solution includes changing the tax base so that there are full deductions for any amounts of money saved or invested. This is equivalent to saying that the tax base should be reformed so that the normal return to saving and investment is not taxed. In addition, fixing the tax base would require changes to how losses are treated; we return to that in Section 3.4.

In the small business context (the focus of our discussion here), the relevant personal tax base is self-employment profits and shares (i.e. equity) in small companies (including in one's own company).<sup>55</sup> In the case of small companies, there is also a second layer of tax levied at the company level, corporation tax, for which the relevant base is taxable company profits.

As shown in Table 2.3, full deduction of investment costs is already available for self-employed people investing their own money in plant and machinery that qualifies for the AIA. But this is not true for equity-financed investments made through companies, even if they qualify for the AIA, because the AIA only

<sup>55</sup> In a wider context, the relevant personal tax base also includes ordinary bank accounts, ISAs, pensions, owner-occupied and buy-to-let housing, arm's-length shareholdings, and any other forms of personal savings.



provides a deduction for the business: there is no deduction against personal tax, so a marginal investment may be free of tax at the company level but the return can still be taxed at the personal level. ISAs and pensions, which do exempt the normal return to saving from personal tax, cannot generally be used to invest in a company that the investor (or a relative) controls.<sup>56</sup>

Beyond that, there is a penalty for equity-financed investment in assets not covered by the AIA, and a subsidy for most debt-financed investment; the size of both of these problems depends on the assets purchased, how long they are held for and the rate of inflation.

There is a variety of ways to design the tax base so that costs are fully deductible or, equivalently, so that normal returns are not taxed. One is not to tax returns to capital at all. At the personal tax level, this is how savings held within ISAs are treated: any returns made within ISAs are tax-free. It has the attraction of simplicity and is appropriate where all returns are expected to be normal (as is likely to be the case with cash ISAs), but not appropriate where excess returns can be significant and especially where labour income can be recharacterised as capital income, as is the case with business owners. There are two other options that exempt the normal returns to capital from tax but ensure that tax is applied to excess returns (and to labour earnings). Both have versions at the personal and corporate level and they produce economically equivalent outcomes.<sup>57</sup>

- A ‘cash-flow’ tax approach gives 100% up-front deductions for all money that is saved or invested and then taxes all incomes when they are received. (The AIA achieves this at the business level for the assets covered.) This approach directly ensures that 100% of investment costs are tax-deductible.
- A ‘deferred-allowances’ approach gives a stream of annual allowances for the normal rate of return to capital previously saved or invested. The net present value of the stream of allowances is equivalent to the 100% up-front allowance provided under the cash-flow approach. This approach leads to a personal

<sup>56</sup> Similarly, most of the tax reliefs associated with venture capital schemes (Venture Capital Trust (VCT), Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme (SEIS) or social investment tax relief (SITR)) are not available if the investor (or a relative) controls the company.

<sup>57</sup> We will describe the two approaches as ‘equivalent’. By that, we mean that, under certain assumptions, they provide the same opportunities for consumption and work at all times. In economic terminology, they create the same budget constraint. Since the options available are the same, people’s optimal choices should also be the same.

income tax with a ‘rate-of-return allowance’ (RRA) and a corporation tax with an Allowance for Corporate Equity (ACE).

Fixing the tax base also requires an adjustment to the tax treatment of borrowing. We could either: keep the current interest deduction but also add a deduction for repayments of principal and tax all principal borrowed (this would be akin to the cash-flow approach); or modify the interest deduction so that only interest payments in excess of a normal rate of return on the outstanding loan would be deductible (this would be akin to the deferred-allowances approach).

The cash-flow and deferred-allowances approaches share many attractive properties, including:

- exempting the normal return to investment from tax, thus avoiding disincentives to invest;
- taxing excess returns to investment (including disguised labour income);
- neutrality across different assets;
- neutrality between debt and equity finance;
- robustness to inflation;
- no lock-in effect of taxing capital gains on realisation;
- no tax advantage to sheltering funds within a company.

We explain below how the two approaches work at the personal and corporate levels. At the end of the section (in Tables 3.6 and 3.7), we set out all of the components that would need to be implemented to achieve either approach and discuss when one of the approaches may be preferred and how elements of each could be combined.

## The cash-flow approach

The cash-flow approach is very simple: all cash inflows are taxed and all cash outflows are deducted – hence the name ‘cash-flow tax’. This implies that there is an immediate 100% tax relief given on any amounts saved or invested.<sup>58</sup>

<sup>58</sup> The benefits of cash-flow taxes have long been known. See Brown (1948), Kaldor (1955), Meade Committee (1978), Bradford and US Treasury Policy Staff (1984) and especially Kay and King (1990).

This type of tax at the personal level is often referred to in economics as an ‘expenditure tax’.<sup>59</sup> Since income that is saved/(re)invested is excluded from taxable income, while money withdrawn from savings to spend is included, the net effect of applying this treatment across the board would be to only tax income when it is used for consumption.<sup>60</sup>

Cash-flow taxes do not discourage saving and investment – at least if the marginal tax rate used to deduct cash outflows is the same as that used to tax inflows; we return to discuss this below.

### Cash-flow tax at the personal level

For investments in shares – including shares that an individual owns in their own company – a cash-flow tax would mean that any money used to buy shares would be deductible from taxable income in that year, and any money received from the shares – dividends or the proceeds of selling them – would be taxable. This could be implemented directly, with people claiming tax relief for individual share purchases and being taxed on dividends and sale proceeds. Or it could be implemented by allowing funds to be invested in shares via a new vehicle, akin to an ISA or a pension. Any amounts put into the new vehicle would be tax-deductible and any withdrawals would be taxed; while inside the vehicle, the money could be invested in shares tax-free. This is an exact description of how income tax currently treats private pensions; a new vehicle could work in the same way, just without the restrictions on withdrawing money before age 55 or the 25% tax-free lump sum that currently apply to pensions. And crucially, unlike a pension fund, the fund could be used to buy shares in an individual’s own company.

The same cash-flow approach can also be applied to investments in fixed assets. In fact, this treatment is already in place for the self-employed when they purchase plant and machinery that qualify for the AIA (or certain other assets attracting 100% first-year allowances): the cost of investment is fully deductible up front and

<sup>59</sup> A cash-flow personal tax treatment is also referred to as EET treatment – meaning that income is exempt (E) from tax at the point at which it is saved or used to purchase an asset; returns (interest, capital gains or distributable profit) are exempt (E) as they accrue; and tax (T) is due when the funds are withdrawn from an account or an asset is sold.

<sup>60</sup> Unlike indirect taxes such as a VAT or a retail sales tax, the tax rate cannot easily depend on what goods or services the money is spent on, but it can more easily depend on the individual’s total spending: it can be made progressive through a tax-free allowance and higher rates, as income tax already is.

any money received from the business – whether from working with the equipment or from selling it – is taxable.

The example in Table 3.2 illustrates the effect of a cash-flow treatment for a marginal investment – that is, one that just returns the initial investment plus a normal rate of return (which we set to be 5%) and therefore breaks even. Recall from Chapter 2 that an efficient tax system requires that an investment that is marginal before tax will continue to be so after tax.

In year 1, an investment of £1,000 is made. This could, for example, represent the purchase of shares in a closely held company (i.e. an equity injection) or the purchase of an asset by an unincorporated business. The £1,000 can be immediately deducted from taxable income. If the tax rate is 20%, the deduction effectively provides a ‘tax shield’ worth £200. This could be used to offset other tax due or, where that was not possible, would represent a loss that could be carried forward or back. In year 2, we assume that the investment makes a return of £50 and the asset is sold for £1,000. £50 reflects the normal return – that is, the return that leaves people exactly indifferent between having the money now or later. Taxable income is £1,050 and the tax due is £210. When evaluating this investment today, the

**Table 3.2. Worked example: personal cash-flow tax**

	Year 1	Year 2
Investment	1,000	0
Income generated	0	50
Sale of asset	0	1,000
<i>Tax position:</i>		
Cash-flow deduction	1,000	0
Taxable income/gain	–1,000	1,050
Tax payment (tax rate = 20%)	–200	210
Present value of tax payments	–200	200 <sup>a</sup>
Total net present value of tax payments		0

<sup>a</sup> The present value of the year 2 tax payment is  $210/(1+\delta)$ , where  $\delta$  is the discount factor, equal to the normal rate of return (0.05 in this example).

Note: The tax payment of –200 in year 1 assumes that the individual has other taxable income against which to offset the loss.

investor discounts the future. Recall from Box 3.2 that the discount rate used for present-value calculations should be the normal rate of return. The present value of the £210 tax payment in year 2 is therefore £200, and the net present value of all tax is therefore zero. When the investment earns exactly the normal rate of return, then by definition the present value of the money ultimately withdrawn to spend will be the same as the present value of the amount saved (i.e. the normal return is not making the investor better off – it is simply preserving the value of the investment). With a constant tax rate, the tax on the money withdrawn (i.e. the £210) will have the same present value as the tax deduction on the amount saved (the £200). The net present value of tax paid is zero, and an investment that was borderline-worthy before tax is still borderline-worthy after tax.

This was clearly a simplified example. But the core intuition holds for more complicated examples. If the initial investment is in an asset that depreciates, the sale value in year 2 will be lower. But if the investment is to earn the normal return overall, the income generated must then be correspondingly higher and the tax base in year 2 would be unchanged. So there would still be no tax on a marginal investment. Note that the deduction in year 1 for the purchase cost of the asset is essentially a 100% first-year allowance: there is no need for any other capital allowances.

If an investment yields more than the normal rate of return, the present value of tax on withdrawals will be greater than the present value of the up-front deduction, so the net present value of tax paid will be positive. That is, a cash-flow tax exempts normal returns but taxes excess returns. Since only a fraction (equal to the tax rate) of the excess return will be taken, a profitable investment will remain profitable (i.e. still yield more than the normal return) and will still be worthwhile as long as the tax rate is below 100%. If the investment yields less than the normal rate of return, the value of the up-front deduction will be greater than the later tax payments, cushioning the blow.

Another way to view the cash-flow tax is to see the government as, in effect, becoming a compulsory partner in the investment, taking a stake equal to the tax rate: when the tax rate is 20%, the government provides 20% of the outlay (via the tax deduction) and takes 20% of the receipts. From the individual's point of view, the scale of the investment simply shrinks by the amount of the government's share. The government takes a share of the benefits and an equal share of the costs. If the

investment is risky, the government is providing a form of insurance, making both the upside and the downside smaller. The individual could accept this insurance and the scaling down of the investment; or if the opportunity is available, she could choose to make a correspondingly bigger investment in the asset, so that her overall after-tax position is the same as it would have been in the absence of tax.

A key benefit of this approach is that it removes the need for many distinctions that are important in the current system. Notably:

- Any cash outlay on the business is deductible; there is no need to distinguish capital expenditure from current expenditure or to determine which category an asset falls into for capital allowance purposes. In fact, as noted above, there is no need to operate capital allowances – the cost of all assets is fully deducted immediately (essentially the cash-flow deduction *is* a 100% first-year capital allowance) and can be ignored thereafter.
- Any cash received is taxable, whether from selling produce, selling assets, or other sources entirely such as employment. There is no need to distinguish what kind of receipt it is, and no need to measure the capital gain (or loss) if an asset is sold (the asset's purchase cost was already deducted at the point of purchase so it is not deducted again at the point of sale).

Since most investment by small businesses already qualifies for the AIA,<sup>61</sup> in practice moving to a cash-flow tax would not make a big difference to most self-employed people's tax bills.<sup>62</sup> However, at the moment, investments in buildings, cars (except the lowest-emission ones), training (unless it is to refresh existing skills), intellectual property, financial assets and non-depreciating assets do not attract 100% capital allowances. Moving to a cash-flow tax (which could be achieved by extending the AIA to all investments) would therefore remove the disincentive to invest in these assets (though some care is needed to ensure that, for example, training in new skills is genuinely for business purposes rather than a

<sup>61</sup> Most small business investment is in plant and machinery. Plant and machinery investment only qualifies for the AIA up to an annual limit (which is currently £1 million and has varied between £25,000 and £1 million over the last 12 years), but this limit is rarely binding for small businesses.

<sup>62</sup> The cash-flow approach also has much in common with the existing 'cash basis' for taxation that the self-employed can already opt into if their annual receipts do not exceed £150,000. Indeed, the cash basis explicitly removes the separation of 'capital' from 'revenue', generally treating the sale and purchases of assets simply as trading income and expenses. But again not all assets are treated like that, and there are some other differences too, such as the treatment of interest payments and additional restrictions on loss offsets. See <https://www.gov.uk/simpler-income-tax-cash-basis> for an introduction to the cash basis and <https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim70000> for detailed information.

hobby – just as caution is already needed for many other purchases that have potential private as well as business uses).

For both shareholders and the self-employed, if income received is reinvested, there would be no tax payable at that point. It makes no difference whether money stays within an investment vehicle or business – such that it is not withdrawn and therefore not taxable – or whether a receipt of taxable income is recorded but then used to make an equal ‘new’ investment, with the tax and the deduction cancelling each other out.<sup>63</sup> Either way there is no tax payable at that stage. Only the net cash flows matter, and only money available for consumption expenditure rather than saved/invested is taxed. Among other things, this implies that there is no ‘lock-in effect’ and no incentive to shelter money within a company (if the tax rate faced is constant).

If we moved to a cash-flow treatment of saving and investment, we would also need to adjust the treatment of borrowing. Otherwise, marginal investments would continue to be subsidised (see the example in Table 2.3 of a debt-financed investment that qualifies for the AIA). There are different options for how borrowing could be treated. These are laid out in Box 3.3. It would seem most natural to adopt a cash-flow treatment of borrowing (option (b) in the box) to go alongside the cash-flow treatment of investment (although we discuss below how a cash-flow treatment of investment could be combined with option (c) for borrowing). A cash-flow treatment of debt would imply that the initial loan was added to taxable income in the year it was taken out, and any repayments of principal as well as interest would be deductible. In the above example, this would imply that taxable income was zero in year 1 (£1,000 of loan minus £1,000 of investment) and zero in year 2 (£1,050 of income minus £1,050 of repayment, assuming an interest rate of 5%). This example shows that with a cash-flow treatment of both investment and debt, the cash flows involved would not be as large as they might sound from the description. If money is borrowed to invest, then the tax on the principal borrowed will be cancelled out by the tax deduction for the amount invested. Relative to the current system, therefore, a cash-flow approach can be thought of as replacing capital allowances for debt-financed investment with a tax deduction for repayments of principal.

<sup>63</sup> The former interpretation is perhaps more natural if this system is implemented via a new ISA/pension-style vehicle for shareholdings, and the latter if implemented directly for individual share transactions, for example; but it does not matter.

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**Box 3.3. Options for the tax treatment of borrowing**

There are three possible ways to treat borrowing that ensure that normal returns are not taxed and that tax does not affect financing decisions:

- (a) Borrowing could be ignored completely. In practice, this amounts to ending the current tax-deductibility of interest payments.
- (b) Borrowing could be taxed on a cash-flow basis. The amount borrowed would be taxable and repayments of principal as well as interest would be deductible.
- (c) Interest payments in excess of a normal rate of return on the outstanding loan could be deductible (while recipients of excess interest payments, typically banks, would be taxed).

If all loans were made at the normal rate of interest, (a) and (c) would be identical, and (b) would be equivalent in present-value terms: the present value of cash inflows and outflows would be the same, netting out at zero.

In practice, loans are usually provided at above-normal interest rates; banks typically lend at higher interest rates than they offer on deposits. This ‘interest rate spread’ represents an implicit charge for financial services, through which banks cover their costs and make profits. In the hands of the bank, this charge for financial services will (rightly) be taxed as profits (after deducting any costs, such as staff wages, incurred in providing the services). In the hands of a business that takes out a loan, the charge for financial services is a business cost and, like other business costs, should be tax-deductible. An interest rate above the normal return may also reflect that a loan is deemed risky, with a chance it would never be paid back. This risk premium should also be deducted at the business level (as a cost of doing business). For these reasons, option (b) or (c) is in principle preferable to option (a) for business loans.

Unlike business borrowing and saving, personal borrowing and saving undertaken for private consumption purposes should be (and is) ignored for tax purposes (i.e. option (a)). This implies that, whatever approach is chosen for business loans, rules to delineate business from personal loans would still be needed. However, such rules would be subject to much less pressure than at present, since they would determine only whether above-normal interest payments, not all interest payments, were deductible.

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The neutrality properties of the cash-flow tax we have demonstrated assumed that the individual faces a constant tax rate, so that the up-front deduction is given at the same rate as the later receipts are taxed. If I expect my tax rate to rise or fall, the properties of the tax are more complicated: saving in a cash-flow vehicle looks attractive if I expect my marginal rate to fall, and unattractive if I expect it to rise.

This is essentially the same issue as we discussed in Section 2.2 in the context of sheltering money within a company: both are ways to forgo taxable income now and pay tax on it when the money is withdrawn instead.

As we discussed there, where expected changes in tax rates reflect changing income, this is not necessarily a bad thing. It allows people to smooth their tax base across years, moving closer to a lifetime tax (which is good), though only for the part of the population able to do it (which is bad). It alleviates the bias towards smoothing earnings across years, but potentially biases people towards smoothing their consumption to the extent that they cannot finance their desired consumption pattern from other savings or borrowing until they can withdraw the money at the lower tax rate. The arguments are finely balanced, and we do not consider this a powerful argument either for or against a cash-flow tax.

### Cash-flow corporation tax

A cash-flow corporation tax (CFCT) mirrors the cash-flow approach to personal tax (which applies to unincorporated businesses) described above: cash inflows are taxed and cash outflows are deducted. To recap:

- The government is in effect taking a compulsory stake in the business, equal to the tax rate. This should not deter investment; marginal investments are untaxed and investments that generate above-normal profits remain worthwhile.
- There would be no need for any capital allowances beyond the cash-flow deduction and no need to distinguish between capital and current spending. All investment costs would be deductible from profits immediately. This would mean little change for most small companies, where the vast majority of investment is already covered by the AIA.<sup>64</sup>

<sup>64</sup> The current regime for taxing profits from oil and gas production also approximates a CFCT.

- All receipts from selling assets, like receipts from selling goods and services, would be taxable immediately, with no need to distinguish between sources of receipts and no need to calculate capital gains.

There are two main versions of the CFCT, which differ in the way they treat financial transactions (parallel to options (a) and (b) in Box 3.3).<sup>65</sup>

- The R base ignores financial transactions, abolishing the deductibility of interest payments and the taxation of interest income.
- The R+F base treats financial cash flows ('F') in the same way as real ('R') cash flows. Amounts borrowed are taxable, while repayments of both interest and principal are deductible; amounts lent or deposited are deductible, while receipts of both interest and principal are taxable.

Both R and R+F bases achieve neutrality towards debt-financed investment – projects that are borderline-worthwhile in the absence of tax remain borderline-worthwhile in the presence of tax – and both achieve neutrality between debt and equity finance. In principle, we prefer the R+F base, which taxes excess returns associated with lending and therefore the net cash flows associated with the provision of financial services. Applied to banks and other financial institutions, it ensures that the profits from interest rate spreads – charging higher interest rates to borrowers than they pay to depositors – are taxed. Applied to banks' business customers – including small companies – it ensures that the charge for financial services they implicitly pay through these interest rate spreads is deductible like other business costs.

The R+F base could be adjusted so that the treatment of borrowing, unlike the rest of the tax, is not done on a cash-flow basis but in a way that is equivalent to it in present-value terms (i.e. borrowing could be treated according to option (c) in Box 3.3). That is, real cash flows would be treated as described above, but the current interest deduction would be modified so that only interest payments above a normal interest rate on the outstanding loan would be deductible. This takes advantage of the equivalence between giving an immediate 100% deduction and giving a stream of deductions at the normal rate of return – something that we explore in the discussion of the deferred-allowances approach below. In effect, starting from an R+F base, the tax on the principal borrowed is carried forward with interest (at the

<sup>65</sup> The following ideas and terminology are attributable to the Meade Committee (1978), though the basic idea of a CFCT can be traced back earlier.

normal rate of return); the carried-forward tax on principal borrowed cancels out the deduction for principal repaid, while the interest associated with the carry-forward offsets the normal component of actual interest payments, leaving only any above-normal interest payments to be deducted.

A third version of the CFCT is the S base. This looks radically different from the other two – indeed, radically different from corporation tax as we know it – though it is in fact admirably simple in itself, and by accounting identity it is exactly equivalent to the R+F base. The S base simply taxes all net cash outflows to shareholders (S). Dividend payments and share (re)purchases are taxable; dividends received from other companies and shares issued/sold are deductible. The S base is equivalent to the R+F base because the total inflow of funds must equal the total outflow of funds. Any net receipt of funds from ‘real’ and ‘financial’ transactions must be for the benefit of shareholders (or the exchequer).<sup>66</sup> For further discussion, see Meade Committee (1978) and IFS Capital Taxes Group (1991).

Table 3.3 summarises the three possible tax bases for a CFCT.

**Table 3.3. Possible bases for a cash-flow corporation tax**

R base	R+F base	S base
Sale of goods, services and assets	Sale of goods, services and assets	(Re)purchase of shares, dividend payments
	Increase in borrowing, interest received	
<i>minus</i>	<i>minus</i>	<i>minus</i>
Purchase of materials and assets, wages	Purchase of materials and assets, wages	Shares issued or sold, dividends received
	Repayment of borrowing, interest paid	

<sup>66</sup> More formally, the symmetry of the balance sheet means that changes in net inflows on the real and financial accounts must be matched by changes in the share account. Any excess of inflows over outflows must be used to pay a dividend or to buy shares in another company.

## The deferred-allowances approach

The deferred-allowances approach is closer to what we might think of as a conventional income or corporation tax: income and capital gains are taxed and there is not a full up-front deduction for any amounts saved or invested. The change from the current system is to introduce a new annual allowance equal to the normal return on amounts saved or invested. At the personal level this is referred to as a rate-of-return allowance (RRA) and at the corporate level as an Allowance for Corporate Equity (ACE).

The intuition for this is straightforward. We have explained that a neutral tax system requires that the normal rate of return not be taxed; an RRA and ACE provide explicit allowances for the normal return, thereby ensuring it is deductible from tax. If exactly the normal return is earned, no tax will be levied (as was the case under a cash-flow tax). Any excess returns will be taxed in full.

The RRA and ACE can also be thought of as a deduction for the (opportunity) cost of equity finance that acts as a counterpart to allowing the interest cost of debt finance to be tax-deductible (some people refer to the ACE as a ‘notional interest deduction’).

Finally, the approach can also equivalently be thought of as a cash-flow tax (which gives tax relief for saving/investment up front), but with deferred rather than immediate tax relief for saving and investment. If the ‘normal’ rate of return is set correctly, the stream of annual allowances under an RRA or ACE will have the same present value as the 100% up-front allowance in a cash-flow tax. That is, in both approaches, 100% of savings or investments are deducted from the tax base in present-value terms (i.e. from the point of view of an investor evaluating the worth of the allowances today), but the RRA or ACE spreads the same present value of deductions over a number of years rather than giving them immediately.

As we explain below, this approach could be combined with any schedule of capital allowances, or no capital allowances at all. The effect of the deferred-allowances approach is to remove the normal return on equity-financed investments from the tax base and to level the playing field between debt and equity finance. It ensures that different assets are treated equally and the present value of tax liabilities does not vary with the rate of inflation, the timing of income or the period for which assets are held.

This approach has not been adopted in any part of the UK tax system. However, an RRA is used to tax dividends and capital gains on shares in Norway<sup>67</sup> and versions of an ACE have been introduced in at least 11 countries. An ACE is currently operating in Belgium, Brazil, Cyprus, Lichtenstein, Malta, Portugal and Turkey; Austria, Croatia, Italy and Latvia have operated ACE in the past but since repealed it.<sup>68</sup> Where the ACE has been repealed, this was not because of any technical flaw or administrative difficulties, but as part of a shift in policy direction – typically to pay for a cut in corporate tax rates.<sup>69</sup> We argue that there is no need for reforms to be revenue-neutral within corporation tax, so an ACE does not require a higher corporation tax rate; the revenue cost of an ACE (which would be low anyway with current near-zero interest rates) could be made up from shareholder taxation or elsewhere. Evaluations of ACE policies suggest that they have been largely effective in reducing the corporate debt bias (Princen, 2012; Branzoli and Caiumi, 2018). For example, the International Monetary Fund (2016) found that the ACE in Belgium resulted in an increase of the equity ratio of around 20 percentage points. (The same study estimated that the debt bias in corporate tax systems increases debt ratios by 7% of total assets on average, including for financial institutions.)

### Rate-of-return allowance at the personal level

In summary, the RRA works as follows:<sup>70</sup>

- Each year, an individual's RRA is calculated as the normal rate of return multiplied by the original purchase price (or, if capital allowances apply, the

<sup>67</sup> For a summary and discussion, see Sørensen (2005 and 2007).

<sup>68</sup> Not all of these are full ACEs operating in the ideal way, and the ACE policies vary in a number of ways, including whether they apply to all or only new equity. For a description of the policies, see Hebous and Klemm (2018, appendix 1) and European Commission (2020, table 2). For discussion, see Klemm (2006). Bond (2000) discusses ACE proposals.

<sup>69</sup> See Keen and King (2002), Massimi and Petroni (2012) and Panteghini and Pighetti (2018). Zangari (2014), International Monetary Fund (2016) and Hebous and Ruf (2017) raise the issue of possible tax avoidance and emphasise the need for anti-avoidance measures. But in fact the main new 'avoidance' opportunities identified either arose because the policy implemented deviated from the textbook ACE described in this report (and the 'avoidance' often amounted to companies' de facto achieving the result a textbook ACE would have achieved anyway) or consisted of multinationals' responding to the ACE by locating more of their equity in the country with an ACE and more of their debt elsewhere (which is not a problem for the ACE-adopting country; it might be a problem for non-adopting countries, which would have more reason to follow suit or else to limit interest deductions). See Mirrlees et al. (2011, ch. 18) and Devereux and Vella (2020) for brief non-technical discussions. In any case, concerns about avoidance have not been a major factor behind the repeal of the ACE in any country.

<sup>70</sup> The rate-of-return allowance was developed and proposed by the economist Peter Birch Sørensen and a government-appointed tax committee in Norway (Skatteutvalget, 2003). See Sørensen (2005 and 2007) for a detailed exposition and discussion.

tax-written-down value) of the individual's business assets, which may include shares in a company or assets of an unincorporated business.

- Income received plus capital gains realised in the current year, minus the RRA for the year, is taxed at the individual's marginal tax rate.
- If the RRA exceeds the income and capital gains realised in a particular year, the unused RRA could be either (i) carried forward to set against returns in later years, marked up by the same interest rate used to determine the RRA, or (ii) added to the purchase price of the assets used for calculating future RRAs and capital gains.
- Capital allowances could be removed completely, or maintained, in any form, with the RRA automatically adjusting to compensate.

This is more straightforward than it may sound. Consider the purchase of £1,000 of shares. For the purpose of the example, we will continue to assume that the normal rate of return is a constant 5%. (In practice, the normal return would be approximated by a risk-free nominal interest rate; we return to discuss this at the end of this subsection.) In each year after the year of purchase, the RRA will be £50 (5% of £1,000). This can be set against any taxable income or gain (i.e. there is a 'tax shield' of £50). If the shares yield exactly the normal return each year, all received as dividends, the £50 RRA each year will offset the £50 of dividends and no tax will be due. Excess (i.e. above-normal) returns will be taxed.

If there is unused RRA one year (for example, if a shareholder does not receive any dividends or realise any capital gains that year), then the investor could either:

- carry forward the unused RRA with interest (i.e. carry forward  $£50 \times 1.05 = £52.50$ ) so the total allowance available in the following year is  $£50 + £52.50 = £102.50$ ; or
- add the unused RRA to the base cost (i.e. add £50 to £1,000), such that the allowance in all future years will be £52.50 (5% of £1,050). In this case, the acquisition cost of the shares at the point of sale will also be deemed to be £1,050.

These two treatments of unused RRAs are equivalent in present-value terms, whatever the nature and timing of returns; the government could let taxpayers choose between the two options, to give them maximum flexibility, though it might be simpler if the government simply decided which system was more straightforward to explain and administer and adopted that one. The core idea in

either case is that any unused RRA is carried forward in such a way that its value is preserved. One way to see this is to consider what happens if the shares are sold in year 3 for £1,102.50 (i.e. having made exactly the normal return of 5% per year). The two scenarios are shown in Table 3.4. If the unused RRA is carried forward, it exactly offsets the capital gain of £102.50. If the unused RRA is instead rolled into the base cost, the capital gain (which is now lower, at £52.50) is equal to the newly calculated RRA. In both cases, taxable income and therefore tax due is zero.

**Table 3.4. Worked example: rate-of-return allowance**

	Year 1	Year 2	Year 3 if RRA carried forward	Year 3 if RRA into base cost
Shares purchased	1,000	0	0	0
Dividends	0	0	0	0
Sale of shares	0	0	1,102.50	1,102.50
Acquisition value for tax purposes	1,000	1,000	1,000.00	1,050.00
Capital gain	0	0	102.50	52.50
RRA	0	£50, unused	102.50	52.50
Taxable income	0	0	0	0

Where people have shares in more than one company, each shareholding could be treated separately, or the person's entire portfolio could be treated as a whole, with the RRA given against the sum of share purchases net of sales made.

There is another way to think of the RRA, as shown by these examples. When an asset is sold, the nominal purchase price is tax-deductible (as the acquisition cost in a CGT calculation). The RRAs can be seen as representing interest payable for deferring the deduction from the point of purchase (when the cash-flow tax would have given relief) to the point of sale. And if the RRAs are rolled up and added to the deductible acquisition cost at the point of disposal, that is another way of saying that the purchase cost is indexed (or stepped up) with the interest rate over the

period the asset was held. If the asset is never disposed of, then the stream of RRAs in perpetuity will have the same present value as the up-front deduction.

When thought of in this way – i.e. where CGT would be levied on an asset's sale price minus its purchase-price-plus-interest and not just its nominal purchase price – the RRA is somewhat familiar in the UK because indexation for inflation was part of CGT (in some form) from 1982 until 2008, and continued in corporation tax until 2017. As such, indexation for an interest rate instead would not be a completely unfamiliar process (though the old indexation system included unnecessary complexities, and greater computerisation would further simplify the process relative to what existed before).

An alternative to implementing a full RRA system as described above would therefore be to reintroduce indexation of capital gains, but for an interest rate (the normal rate of return) rather than an inflation rate. If this were done, it would be even more important to ensure that capital losses could be fully offset, since losses relative to such an indexed base cost would be bigger and more common than the nominal losses potentially eligible for relief under the current system. (We return to discuss the treatment of losses in Section 3.4.)

The taxation of capital gains creates no lock-in effect with an RRA system (as we would expect, since it is equivalent to a cash-flow tax, which no-one would suggest creates lock-in effects). The lock-in effect arises because tax is paid earlier if a capital gain is realised and the proceeds reinvested than if the original asset is retained and sold later; since deferring tax is valuable, this creates an incentive to 'shield' the gain from tax by holding on to the original asset for as long as possible rather than switching to a different one.<sup>71</sup> With an RRA, the reinvestment of the realised capital gain creates an additional stream of future allowances which exactly compensates for the cost of paying the tax earlier. For the same reason, more broadly it does not matter for tax whether any returns to investment are paid out and then reinvested or are shielded and rolled up within an asset, company or other vehicle: the RRA ensures that the tax base has the same present value in any case.

The RRA operates in a similar way for the self-employed: the RRA is calculated each year as the normal rate of return multiplied by the purchase price of the

<sup>71</sup> As we noted in Section 2.2, this effect is currently mitigated where business asset rollover relief or EIS reinvestment relief is available.



asset(s). The additional question that arises in this case is how the RRA interacts with capital allowances. There are two ways this could be done: there could be no capital allowances at all, or there could be any pattern of capital allowances, but with a corresponding adjustment to the RRA.

The purest, and in some ways the simplest, approach would be not to have any capital allowances. If the asset is never sold (that is, is kept until it no longer has any value), the infinite stream of RRA allowances is equivalent in present-value terms to an up-front deduction; if the asset is sold, the full price of the investment is tax-deductible at that point and the stream of allowances until that point provides compensation for the delay in receiving the deduction. Nothing more is needed to ensure that the tax system is neutral.

Replacing existing capital allowances with an RRA might seem like a big reduction in generosity, since capital allowances are usually much more than a few percent per year. But there is also a key difference when an asset is sold. Under the current system of capital allowances, CGT is paid on the sale price minus the *tax-written-down* cost of the asset (i.e. the purchase price less any capital allowances already claimed). For example, if an asset is sold after being fully ‘written down’, the entire sale proceeds are taxable (see Table 2.3 for an example). In contrast, if capital allowances were replaced by an RRA, only any rise in value relative to the initial purchase price would be taxable (and only then in so far as it exceeded any unused RRAs carried forward). So, under an RRA, the purchase price of the asset is deductible at point of disposal *as well as* the stream of allowances received in the meantime; whereas capital allowances make the purchase price deductible (immediately or gradually) earlier than the point of disposal. Of course, if the asset is never sold, then this difference at point of sale is irrelevant. But if the asset is never sold, then the stream of RRAs will continue forever<sup>72</sup> – even after the asset has fully depreciated – and, by construction, that perpetual stream of allowances will have the same present value as a 100% up-front deduction. The stream of RRAs compensates for the delay in deducting the purchase cost of the asset – even if that delay lasts forever.

<sup>72</sup> Of course, businesses do not last forever. If trading ceases, then the original purchase cost should be deducted at that point. When a firm is liquidated, all its assets are disposed of, so the deduction of the purchase cost when trading ceases can be thought of as reflecting a disposal at point of liquidation, even if in practice the asset is not actually sold when trading ceases. Of course, the treatment of capital losses at that point then becomes important.

Alternatively, the RRA could exist alongside capital allowances, with the RRA calculated as the normal return times the tax-written-down value of assets purchased – i.e. any capital allowances claimed would be deducted from the purchase cost of the asset when calculating the RRA. Essentially, we would give an RRA for any investment not yet recognised through capital allowances. The beauty of the RRA is that it then delivers neutrality regardless of what capital allowance schedule is chosen. If all investments qualified for 100% first-year allowances (for example, through an expanded AIA) then there would be no RRAs at all and the system becomes a cash-flow tax.

Following from the example in Table 3.4, again suppose that there is an initial £1,000 investment, this time in a depreciable asset. Assume that the investment yields income each year that exactly covers depreciation plus a normal return, so in the absence of tax the investment would be marginal. In Table 3.5, we initially assume (Case 1) that capital allowances match actual economic depreciation, with the asset losing a fifth of its original value each year and the capital allowances regime correspondingly providing a deduction for 20% of the original cost (that is, on a ‘straight-line’ basis) for each of the first five years after the year of purchase. The RRA would be calculated based on the tax-written-down value of the asset at the start of the year, i.e. the purchase cost minus any capital allowances previously claimed. In year 2, therefore, the RRA will be £50 (5% of £1,000), but in subsequent years the RRAs will be £40, £30, £20, £10 and, after year 6 (once the asset had been fully written down for tax purposes), there would be no more RRAs. With a 5% discount rate, the stream of RRAs exactly compensates for deducting the £1,000 purchase cost gradually rather than immediately. Expressed in year-1 terms, the net present value of the stream of capital allowances is £866 (i.e. less than the initial £1,000 investment), but the NPV of the stream of RRAs is £134, and together they are exactly £1,000. This is the key. Because the RRA adjusts according to the capital allowances, it does not matter what the capital allowances are. The more generous the capital allowances, the less generous the RRA, so that the sum of the two always has the same present value as a 100% first-year allowance.

This is illustrated by comparing Case 1 (where deductions match income each year – capital allowances covering depreciation and RRAs covering the normal rate of return – such that there is no tax due in any year) and Case 2, where capital allowances are more generous than true depreciation: 25% a year over four years, rather than 20% a year over five years. Since each year’s RRA is 5% of the tax-

Table 3.5. Worked example: rate-of-return allowance with depreciation

	1	2	3	4	5	6
<b>Case 1: capital allowances match true depreciation</b>						
True value of the asset	1,000	800	600	400	200	0
Value of asset for tax	1,000	800	600	400	200	0
Income		250	240	230	220	210
Capital allowance		200	200	200	200	200
RRA		50	40	30	20	10
Taxable income		0	0	0	0	0
<b>Case 2: capital allowances exceed true depreciation</b>						
True value of the asset	1,000	800	600	400	200	0
Value of asset for tax	1,000	750	500	250	0	0
Income		250	240	230	220	210
Capital allowance		250	250	250	250	0
RRA		50	37.5	25	12.5	0
Taxable income		−50	−47.5	−45	−42.5	210
<b>Case 3: asset yields capital gain rather than income</b>						
True value of the asset	1,000	1,050	1,102.5	1,157.6	1,215.5	1,276.3
Value of asset for tax	1,000	800	600	400	200	0
Income		0	0	0	0	0
Capital allowance		200	200	200	200	200
RRA		50	40	30	20	10
Sale price of asset						1,276.3
Taxable income		−250	−240	−230	−220	1,066.3

Note: In all three cases, the NPV of the stream of capital allowances plus RRA is 1,000 (expressed in year-1 terms) and the NPV of the stream of taxable income is zero.

written-down value of the asset, the higher capital allowances translate into lower RRAs than in Case 1. In present-value terms, the lower RRAs exactly balance the accelerated capital allowances: this time the NPV of the capital allowances is £886, while the NPV of the stream of RRAs is £114, but they still sum to the £1000 purchase cost of the asset. In this case, there are unused allowances in each year ('tax shields' that could be used to offset other taxable income), until in year 6 there

are no more allowances and the income is taxable in full. The NPV of taxable income across all six years is zero.

Finally, we note that the RRA produces the same outcome if there is no income or depreciation at all and all of the 5%-a-year return comes as a capital gain; this is shown in Case 3, assuming the same capital allowance schedule (and therefore the same RRAs) as in Case 1. When the asset is sold in year 6, tax is due on the full sale price (relative to the written-down value of zero, the full sale price represents a capital gain). Again, the RRA ensures that the NPV of deductions equals the asset's purchase cost, so with the investment yielding just the normal return, the net present value of taxable income across all years is zero.

To summarise: the choice of capital allowance schedule would no longer matter for the present value of the tax base. The RRA exactly compensates for any delay in receiving capital allowances for the purchase cost of the asset. If there were a 100% first-year allowance, there would be no RRA. If there were no capital allowances, there would be annual RRAs for the full purchase cost. And if capital allowances were provided over a number of years, there would be an RRA each year for the amount not yet written down.

Since, as noted above, most small business investment already qualifies for immediate deductions, this means that introducing an RRA could be only a small tweak to the existing system for taxing unincorporated businesses: RRAs would only be given for assets that did not already qualify for 100% first-year allowances – and even then only to the extent that, and for as long as, other capital allowances had not fully covered the cost.

Introducing an RRA would achieve neutrality (at the personal tax level) for investments financed from the investor's own money. To achieve neutrality with respect to debt-financed investment, we must ensure an appropriate treatment of debt. Any of the options in Box 3.3 would be possible, but it would be most natural to combine an RRA with a modification to interest deductibility that allowed only interest payments above the normal return to be deducted (option (c) in Box 3.3). This could be done as an explicit reform to the tax deductibility of debt interest. Alternatively, the same result could be achieved as an integral part of the RRA itself, by calculating the RRA by reference to the written-down value of business assets *net of outstanding business debt*. Denying an allowance for the normal return

to debt is clearly equivalent to ending the deduction for the normal interest on debt: both increase the tax base by the normal rate of return times the stock of debt. The government could choose whichever way of describing and implementing the system it found simplest.

An RRA would be more complex, in at least some cases, than the current regime. It would require more record-keeping for some – though no more than is needed for CGT to operate – and the calculations involved would be unfamiliar. But particularly (though not only) if combined with closer rate alignment, it could simplify the capital tax system as a whole by reducing the tax discrepancies between different (or differently labelled) activities and the corresponding opportunities for avoidance, and hence reducing the plethora of concomitant laws and regulations designed to minimise avoidance and reducing the pressure on those that remain. For example, it would no longer matter much whether a particular purchase was treated as current or capital expenditure, or whether the part of a shareholding being sold was treated as being the part that had been acquired first or last (so-called ‘first-in-first-out’ versus ‘last-in-first-out’ accounting).

There is a limit to concerns about the complexity of an RRA, as using it would be optional. Investors could claim an RRA. If they did not take that option, their investments would, by default, be taxed under a standard income tax regime similar to the one currently in place. There would clearly be a financial benefit to using the RRA, but no obligation for those with relatively small holdings or a strong aversion to extra record-keeping and calculations.

### Allowance for Corporate Equity at the corporate level

The Allowance for Corporate Equity (ACE) approach at the corporate level is analogous to the RRA approach to personal taxation. This approach starts with a conventional measure of profits but provides an additional allowance for a normal rate of return to equity invested in the business.<sup>73</sup>

In summary, the ACE works as follows. Each year, the ACE is calculated as the normal rate of return multiplied by the equity stock (the stock of shareholders’ funds) at the end of the previous year. The equity stock at the end of the year is

<sup>73</sup> The ACE was developed and proposed by the IFS Capital Taxes Group (1991), building on earlier work by Boadway and Bruce (1984). Bond (2000), Mirrlees et al. (2011, chs 17–18) and Devereux and Vella (2020) provide good non-technical overviews and discussions.

calculated as: the stock at the start of the year + net equity issued + retained taxable profits, where:

- net equity issued/sold includes new shares issued (net of share buy-backs) and the sale of any shares in other companies, notably subsidiaries (net of acquisitions of such shares);
- retained taxable profits are profits as computed for tax purposes (gross of the ACE allowance itself) minus tax paid to the government and dividends paid to shareholders.

The beauty of the ACE is that its design creates automatic balancing mechanisms which deliver neutrality without the need to change the capital allowance schedule, taxation of capital gains on realisation, the deductibility of interest payments or the lack of allowance for inflation. This is achieved because the measure of the equity base used to compute this tax allowance is explicitly related to taxable profits and therefore to the capital allowance schedule.

Compare the sequence of capital allowances and ACE allowances in the case of an asset for which the capital allowance schedule is ‘right’ (i.e. matches true economic depreciation) with those for an asset where capital allowances are less than true depreciation. For such an asset, where the tax schedule initially underestimates the true cost of depreciation, the depreciation allowances will be ‘too low’ in the early years of the asset’s life, resulting in taxable profits and tax payments that are initially ‘too high’. However, retained profits as computed for tax purposes will then also be higher than they would otherwise be, resulting in a higher stock of shareholders’ funds used to compute the ACE allowance in future years. As a result, future ACE allowances will be higher, and future tax payments will be lower.<sup>74</sup> These two effects can be shown to offset each other precisely in present-value terms, so that the present value of the stream of tax payments under the ACE tax base does not depend on the details of the depreciation schedule used.<sup>75</sup> That is, factors that affect when profits are taxed, such as the capital allowance schedule and the realisation of capital gains, do not affect the present value of tax paid. The ACE always ensures that tax is payable only to the extent that the company earns above-normal returns on shareholders’ money.

<sup>74</sup> The converse applies for assets where capital allowances exceed true economic depreciation.

<sup>75</sup> This useful property of the ACE tax base was demonstrated in IFS Capital Taxes Group (1991), building on earlier work by Boadway and Bruce (1984).

The implication is that, just as with an RRA, it would not matter (for the neutrality of corporation tax) whether there were no capital allowances, or 100% first-year allowances, or anything in between: the generosity of the ACE changes to reflect the fact that capital allowances are more/less generous – or the fact that (higher) inflation reduces the real value of capital allowances and the real value of interest payments. Since, as noted above, most small companies' investment is covered by the AIA, introducing an ACE with the current capital allowance regime would actually mean very little by way of new allowances for small companies. Just as an RRA reduces to a cash-flow personal tax if there are 100% first-year allowances, the ACE reduces to a cash-flow corporation tax (with an 'R+F' base).<sup>76</sup>

The ACE tax base could be indexed to deal with inflation, but this is not needed. The intuition here is that the same deduction for the cost of equity finance can be computed either by indexing the equity base in line with inflation over the previous year and then computing the opportunity cost using a real interest rate; or more simply by not inflation-adjusting the equity base, but computing the opportunity cost using a nominal interest rate. Provided the ACE allowance is calculated by applying a nominal interest rate to the unindexed equity base, also allowing nominal interest payments to be deducted then provides the appropriate tax relief for the cost of debt finance in the presence of inflation.<sup>77</sup>

The ACE corporation tax would allow nominal interest payments to be deducted from the corporate tax base and would tax nominal interest receipts, so that profits from interest margins are taxed in the case of banks and other financial intermediaries. The treatments of debt-financed and equity-financed investments are equivalent in present-value terms, and also similar in relation to the timing of

<sup>76</sup> To see this, suppose a profitable company issues £100 of new equity and uses the money to buy a £100 asset. If there are no capital allowances, the £100 added to the equity stock generates additional allowances of (say) £5 a year to deduct from taxable profits in all future years. But if instead the asset qualifies for the AIA, then while the £100 equity issue adds £100 to the equity stock, the AIA reduces taxable profits, and therefore the equity stock, by the same £100, so overall the equity stock is unchanged and there is no additional stream of future allowances. Thus with 100% first-year allowances, investment is deducted from taxable profits when it is made, while any additional revenue it generates is taxed as it arises: exactly the same as a cash-flow tax. There is no additional ACE to complicate matters. The example is exactly the same if the £100 comes from retained profits ('internal equity') rather than a new share issue ('external equity'): retaining an extra £100 of profits adds to the equity stock in exactly the same way as issuing new equity. We assume the company has other profits so that we can abstract from the issue of how losses are treated if capital allowances create a tax loss.

<sup>77</sup> The deduction of nominal interest payments from taxable profits will again be reflected in the computation of retained profits for tax purposes used to determine future ACE allowances.

tax payments if tax depreciation schedules approximate true depreciation. In principle, the ACE approach should not distort financing choices.

Marginal investments attract no tax in present-value terms, regardless of how they are financed. Revenue is raised from projects that earn above-normal returns.

The ACE would add an extra element in the corporation tax calculation, making it slightly more complicated, but again that would be compensated by the simplifications associated with greater neutrality. While the prospect of an ACE might be intimidating because it is unfamiliar, the extra complexity involved would be relatively minor and the departure from the current system would not be as radical as might be supposed. Implementation of the ACE approach would preserve most of the structure of existing corporate income taxes, including capital allowance schedules and interest deductibility. All that would be required would be to specify how the equity base used to compute the ACE evolves over time, as described above, and which particular interest rate is used to calculate the allowance.

### Setting the rate of the allowance

The properties of these tax bases depend on using the appropriate interest rate to compute the RRA and ACE allowances. Given that future returns on investment projects may be highly uncertain and shareholders are likely to be risk-averse, this may appear to be a formidable problem. Generally, shareholders will not be willing to invest in risky projects whose expected rate of return is no higher than the interest rate they can earn on safe assets. The gap between the expected rate of return they require and the risk-free interest rate is known as the risk premium component of the required (expected) rate of return. This is likely to vary widely across different investment projects, and no single rate would be appropriate for firms that invest in many different assets. Fortunately, under quite general assumptions about the way in which risky assets are valued by investors, this information is not needed to implement the RRA or ACE, and the appropriate rate to compute the allowance turns out to be the risk-free (nominal) interest rate: exactly the normal rate of return we discussed in Box 3.2.<sup>78</sup>

<sup>78</sup> This convenient result was shown for the ACE by Bond and Devereux (1995 and 2003), building on earlier work by Fane (1987). Sørensen (2005) extends the same logic to the RRA.



The intuition for using a risk-free interest rate comes from thinking about the stream of RRA or ACE allowances for a particular investment project not explicitly as tax relief for the minimum (expected) rate of return required by equity investors in each period, but rather as an alternative to the immediate deduction for investment under the (personal or corporate) cash-flow tax. Suppose a firm invests £1,000 in an asset that lasts forever and that does not depreciate in value. The cash-flow tax gives an allowance of £1,000 in the first period. If we assume for simplicity that there is no inflation and the risk-free (real) interest rate is constant at 5%, the RRA or ACE instead gives a perpetual stream of allowances of £50 per year, with a present value (discounted at 5%) also of £1,000. Provided investors are indifferent between receiving £1,000 now or £50 per year forever, the deferred-allowances approach has the same neutrality properties as the cash-flow tax outlined in the previous subsection. If instead the RRA/ACE were to be calculated using a higher interest rate than the risk-free rate, the value of the tax relief provided by the deferred allowances would then exceed that provided by the cash-flow tax. The effect would then be to reduce the minimum required (expected) pre-tax rate of return below that which would be required in the absence of the tax, and corporate investment decisions would be distorted.

In practice, the risk-free nominal interest rate could be measured as the nominal interest rate on medium-term government bonds. This interest rate fluctuates, and to maintain neutrality across assets and across time, one would ideally like to ensure that the risk-free rate allowed by the tax code varied closely with it. But this clearly complicates administration, and there will always be a trade-off between varying the rate too frequently and maintaining strict neutrality.

Putting aside the frequency of change, using a risk-free nominal interest rate to calculate RRA/ACE allowances will be neutral only if investors are certain that they will benefit from the full stream of deferred allowances over the lifetime of the project. If they are not, the expected value of the stream of allowances will be lower than that of a cash-flow deduction.

Ensuring that the allowances are received in full requires the tax system to have two features:

- If the sum of the taxpayer's income and capital gain in a particular year is less than the allowance so that the allowance cannot fully be used, the unused

allowance must be carried forward (or back) with interest to preserve its value. Unutilised allowances are analogous to losses that can arise under a standard income tax, CGT or corporation tax, but ‘losses’ relative to a normal rate of return will be more prevalent than the losses in absolute terms that arise in standard income and capital gains taxes: nominal returns are below a positive rate-of-return allowance more often than they are below zero. We described above the options for how unused RRAs should be treated to preserve their value. Similar options in principle exist for the ACE, but the simplest approach in that case is to treat unused equity allowances like any other unutilised allowances or losses; we discuss in Sections 3.4 and 5.2 how tax policy should be reformed to treat losses more symmetrically to profits (including carrying forward losses with interest if they cannot be relieved immediately) and minimise disincentives for risky investment.

- An appropriate tax credit/refund would need to be provided in the event of bankruptcy or liquidation of a business.<sup>79</sup>

If these conditions do not hold, there is a case for adding a risk premium to the normal rate of return used for calculating the RRA/ACE allowance. But crucially, that risk premium should reflect only the risk that future RRA/ACE allowances will not be paid out in full, not the uncertainty about the underlying future returns on the project to equity investors. The size of the risk premium needed would therefore depend on the precise rules that were applied to unused allowances, losses and liquidations.<sup>80</sup>

In practice, any such risk premium would have to be applied uniformly, whereas the true risk that allowances would not be received in full would vary between investments, so this would not achieve neutrality perfectly in every case. But note that the extent to which a risk premium is needed at all is within policymakers’ control. The further policy goes towards providing appropriate rules for unused

<sup>79</sup> Bond and Devereux (2003) set out the specific tax rules that are needed for an ACE in the event of firm closure or bankruptcy.

<sup>80</sup> The risk of loss-making and bankruptcy is clearly related to the risk of defaulting on debts, so Griffith, Hines and Sørensen (2010, 977) suggest using the (average) interest rate on corporate bonds rather than government bonds to calculate the ACE – the difference between those two interest rates reflecting the higher likelihood of default among companies than governments. However, while there will clearly be some relationship between the risk of default and the risk that deferred allowances are never received in full, the average risk premium on corporate bonds may not be a good estimate of the average expected shortfall in full receipt of ACE allowances, which, as noted in the text, would depend on the precise rules applied to unused allowances, losses and liquidations.

allowances (and losses more generally) and liquidation, the better using a simple risk-free return such as a government bond rate will perform.

### Options for fixing the tax base compared

As we set out in the introduction to this section, the cash-flow approach and the deferred-allowances (i.e. RRA and ACE) approach offer many of the same benefits.

Yet in other respects they can differ: administration, the timing (though not the present value) of government revenue, asset portfolios and prices, and their properties in transition and adjustment. They can also differ if the assumptions required for the two options to be equivalent do not hold, and in particular if people face different tax rates over time (either because of policy reforms or because they move into a different tax bracket).

These differences provide a basis for choosing between the two approaches. Table 3.6 summarises the pros and cons of the cash-flow and RRA/ACE approaches.

The choice is not a binary one.

- An RRA and ACE are compatible with any schedule of capital allowances. The closer capital allowances are to 100% first-year allowances, the more closely the RRA/ACE treatment of investment resembles a cash-flow tax.<sup>81</sup>
- It would be possible to combine a cash-flow treatment of investment with a treatment of debt that ignores a specified ‘normal’ return and targets above-normal interest payments (i.e. option (c) in Box 3.3).
- It would also be possible to combine a cash-flow personal tax with an ACE at the corporate level, or an RRA at the personal level with a cash-flow corporation tax.

In pure economic terms, there is nothing wrong with any of these hybrids. The key requirement is to ensure that all investment gets a full deduction – either immediately or with interest for deferral – for both personal and (where applicable) corporate tax, and that all receipts net of that deduction are taxed in full. Any combination of features that achieves this will have the same economic effects, and

<sup>81</sup> Introducing an RRA/ACE but with 100% first-year allowances up to a cap (like the cap on the AIA) would in effect apply a cash-flow treatment to small firms (at least for equity-financed investment), with the RRA/ACE restricted to larger firms.

**Table 3.6. Choosing between cash-flow and deferred-allowances approaches**

Issue	Advantages of cash-flow approach	Advantages of RRA/ACE approach
Neutrality	Neutrality does not depend on specifying the correct 'normal' rate of return.	Neutrality less sensitive to varying tax rates (though no feasible system is completely neutral when tax rates vary).
Simplicity	Less record-keeping required: other than carrying losses forward/back, depends only on cash flows within the tax year. Removes many complex features of current system.	
Familiarity and continuity	More familiar (from pensions, AIA, North Sea, VAT, etc.) than the use of allowances for a normal rate of return.	Other than the new (RRA/ACE) allowances themselves, can preserve almost all features of conventional profit/income taxation.
Timing of reliefs	Up-front deductions help credit-constrained individuals and start-ups.	No up-front deductions means less need to deal with losses and less revenue risk, and helps short-termist governments if they care about the timing of revenue rather than its present value.
Policy risk	Less risk of policy change leading to double taxation.	Less risk of policy change leading to (double) non-taxation.

some forms of hybrid might be rather attractive. Taxpayers could even be allowed to choose between equivalent options. But it might be easier to explain the logic of a new system if a consistent approach is followed throughout.

### Summary of components needed to fix the tax base

In Table 3.7, we summarise all of the elements that would need to be changed or implemented if adopting either a cash-flow or a deferred-allowances approach. We also suggest steps that could be taken towards certain components. These can be

seen as a menu of components from which policymakers could choose. We return in Chapter 4 to discuss how policymakers could go about making those choices and managing the inherent trade-offs that arise when a tax is only partially reformed.

**Table 3.7. Components of tax base reform**

Components of cash-flow approach	
<b>1 Give tax relief for share purchases (including in own company) and tax the full proceeds from selling shares (as well as dividends)</b>	
This could be done directly for individual shareholdings or by giving relief for contributions made into a new vehicle and taxing withdrawals from it, with no tax on returns within the vehicle.	
<i>Moves towards this:</i>	
<ul style="list-style-type: none"> <li>• Tax relief could be provided for a subset of shares – e.g. only new equity or only small or closely held companies.</li> <li>• There could be a cap on the amount that could be invested; this could be determined on a lifetime or annual basis, and could be based on contributions or fund size.</li> </ul>	
<b>2 Give 100% first-year allowances (or extend AIA) for all real investments</b>	
There would be no need for capital allowances for subsequent depreciation. Relative to current treatment, the main differences would be the treatment of some forms of training, cars, buildings and investment above the AIA.	
Note that this automatically implies taxing full sale proceeds, not just capital gains.	
<i>Moves towards this:</i>	
<ul style="list-style-type: none"> <li>• The AIA could be extended to more but not all investments.</li> <li>• There could be a cap on the amount of eligible investment.</li> </ul>	
<b>3 Reform treatment of business borrowing</b>	
This could be done by either:	
<b>3a</b> taxing the principal borrowed and deducting the principal repaid as well as interest; or	
<b>3b</b> restricting deductibility of interest payments (and taxation of interest income) to interest rates above the normal return.	

### Components of deferred-allowances approach

#### 4 Introduce an RRA for share purchases

As with a personal cash-flow tax, this could be done directly or via a new vehicle for holding shares.

*Moves towards this:*

- As with a cash-flow tax, there could be a cap and/or restrictions on eligible investments.
- Capital gains could be indexed for an inflation or interest rate.
- An RRA could be introduced with a reduced but non-zero tax rate on the normal return.

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#### 5 Introduce an RRA for written-down value of unincorporated business assets net of outstanding business debt

In other words, introduce an RRA for assets gross of debt, *and* restrict deductibility of interest payments (and taxation of interest income) to interest rates above the normal return.

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#### 6 Introduce an ACE

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## 3.4 The treatment of losses

In order to minimise the extent to which the tax system discourages risk-taking, taxes on income or capital gains (above normal returns to investment) should be matched by equally generous relief for those making ‘losses’ (including below-normal returns). This is needed at both the personal and corporate levels. As we discussed in Section 2.2, the symmetric treatment of profits and losses can be seen as the government taking an equal share in both the upside and the downside of a risky project. If we fail to treat losses in an equivalent way to profits/gains then the expected tax on (normal) returns to risky projects would be positive, undermining neutrality both over the level of investment and between more and less risky activities.<sup>82</sup> As we noted above, losses would be larger under a reformed tax base, especially where there was a greater prevalence of immediate 100% allowances for investment.

<sup>82</sup> As we explained in Section 3.1, symmetric treatment of losses (or equivalent) is necessary to avoid disincentives for risk-taking, but not sufficient. With graduated tax rates, there would still be disincentives for risk. But moving towards symmetric loss offsets would be a big improvement.

At present, there are various restrictions on how losses can be offset. The rules are complicated, but very broadly, trading losses can be offset fairly flexibly against other income in the same year, but if they cannot be then they can be carried back for up to one year (in most cases) or carried forward indefinitely, in which case companies continuing the same trade can set them against any profits but self-employed traders can only set them against profits from the same trade. Capital losses can usually only be offset against capital gains, even in the same year, and can be carried forward indefinitely but only carried back in very limited circumstances.<sup>83</sup>

Loss offsets are incomplete in the sense that there are some losses that will not be relieved at all and those that are carried forward fall in value because of the delay in offsetting them: they are carried forward without interest. In a few cases (carried-back losses and in the restricted circumstances where capital losses can be set against income), the current rules are more generous than symmetric treatment. And it is worth noting that the ability of new business owners to change their legal form can allow them to make the most of the rules. For example, a new entrepreneur may be able to start operating a business through self-employment and, if they make losses early on, offset these against other personal income (potentially at a high tax rate). Once a profit is being made, the business owner can incorporate in order to access lower rates of capital taxes.<sup>84</sup> In some such cases, losses could be offset at a higher rate than corresponding profit/gain would be taxed, which also creates distortions.

Table 3.8 sets out the changes that would be required in order to provide full loss offsets (if we ignored practicalities) and a set of options for moving towards these. Most of the options involve letting people offset their losses against a broader range of income (although losses should never be offset at a higher rate than corresponding income/gains would be taxed). There are, however, genuine concerns about the use of artificial losses for tax evasion and avoidance; this has been a major concern for HMRC over many years. Any changes in this area would need to be mindful of the need not to open new loopholes. We discuss specific changes in more detail in Section 5.2.

<sup>83</sup> There are caps on the use of losses, and additional restrictions on banks etc., but since our focus is on small businesses we do not examine those here.

<sup>84</sup> Gentry and Hubbard (2000) discuss this in the context of the US.

Table 3.8. Components of theoretically ideal loss relief

### Components of allowing full loss offsets

For loss offsets to be fully symmetric to treatment of profits – equivalent to giving tax refunds for losses – would theoretically require all of the following:

- Allow unused losses to be offset against income/gains from any source in any year (including indefinite carry-back).
- Carry losses forward and back with interest to maintain their present value.
- Remove any caps on the amount of losses that can be offset.

*Possible moves towards this (subject to ensuring sufficient protections against abuse):*

- **Allow carried-forward self-employment losses to be set against any income or capital gains**, not just profits from the same trade.
- **Allow individuals and companies to offset capital losses against income (rather than capital gains) in a wider range of circumstances**, beyond offsetting capital losses on shares in unlisted trading companies against income in the same/previous year. However, when individuals offset capital losses against income rather than capital gains, the rate of relief should be restricted to the CGT rate, not the income tax rate.
- **Allow losses to be carried back up to five years.**
- **Remove £50,000 cap** on income tax relief for losses.



## 4. Building pathways to well-designed taxes

The previous chapter sets out a design for a tax system that removes most of the distortions that plague the current tax treatment of different legal forms. It represents a significant prize. Under such a system we would, for example, no longer expect to see tax acting as a significant driver of legal form. People would choose to operate in the form that best suited them and made most commercial sense, and since there would be no big tax differences between similar activities there would be little need to police boundaries; the widely hated IR35 anti-avoidance rules would be virtually obsolete. In addition, the tax system would do little to distort choices over who invests, how much they invest or the assets and financing they choose. Our system would be more robust to changes in work patterns and technologies in future.

Even if the political will existed, it might not be sensible to implement such a large and radical change overnight. It would be sensible for a government to publish a road map that set out a path towards a stated end goal and the reasoning behind it. It would take time to fine-tune the details of the reforms and to make the necessary legislative and operational changes. There could be consultation on some of the elements of the end goal and of the steps towards it. Providing a sense of direction would give people time to plan for change.

However, caution is needed in making incremental changes. The taxation of employees versus the self-employed versus company owner-managers sits at the intersection between taxes on earnings, savings and profits. Changing any one element in isolation can be the policy equivalent of ‘whack-a-mole’: one problem is solved but another one pops up elsewhere in the system. There is plenty of precedent for tax policies that have worsened distortions.

We propose that a workable solution is to create ‘packages’ of policies that can provide stepping stones towards full system change but that would also be desirable

in their own right. This is less straightforward than it may sound. In many ways, designing packages is harder than designing the overall system because there are more trade-offs that must be managed. There are plenty of bad ways to adjust policy but no ‘right’ set of packages or pathway. Ultimately, policymakers must weigh up different considerations and make choices.

In what follows, we discuss how one can go about creating packages and the different criteria that could be used. Our aim is to provide a framework that can be used to help plan policy changes that improve the overall tax system. In Chapter 5, we present some examples of possible packages that we think arguably move the tax system in the right direction, and the trade-offs they involve.

## Key findings

- 1 Caution is required in designing incremental policy steps. Attempting to fix any one issue in isolation can create or exacerbate problems elsewhere in the tax system.
- 2 Particular attention should be paid to how any changes affect the relative attractiveness of different legal forms and to how increases in tax rates would worsen distortions that arise as a result of a poorly designed tax base.
- 3 There are various ways that policies could be packaged together to mitigate at least some of the trade-offs inherent in making reforms to one part of a complex system. There are plenty of bad policy options, but there is no one ‘right’ package or pathway towards a better-designed tax system; all options involve trade-offs.
- 4 Packages could be designed to be revenue-neutral if that were deemed desirable. But there is no way to make meaningful changes without creating losers.

## 4.1 Problems when making incremental changes

Tables 3.7 and 3.8 set out all of the components of tax base reform that would need to be enacted as part of the long-run ideal we have described. These, alongside the options for rate alignment set out in Section 3.2, can be viewed as the set of policies that policymakers should ultimately be looking to introduce, but they might want to do so a bit at a time.

However, care should be taken in making any smaller policy moves in isolation. In making any incremental changes, it is often the case that one problem will be alleviated but others worsened. In relation to the components of tax base reform we have laid out, moves in isolation would entail the following trade-offs:

- Reforms to the tax base that provide a more generous treatment of investment or equity finance (i.e. options 1, 2, 4, 5 and 6 in Table 3.7) or losses (any options in Table 3.8) would make self-employment and/or incorporation even more favoured relative to employment.
- Those measures that apply specifically to companies (options 1 and 4 in Table 3.7) would make incorporation even more favoured relative to an unincorporated form.
- A move to give more generous treatment of all investment (for example, a broadening of the AIA without any adjustment to the treatment of borrowing) would further increase the subsidy for debt-financed investment (though not relative to equity-financed investment).
- Any reduction in the generosity of the treatment of debt would discourage debt-financed investment in non-AIA assets (a bigger issue for larger firms).

Changes in tax rates can affect both the relative incentives to operate in different legal forms and the seriousness of distortions present in the tax base. The main effects are:

- Increasing any of the tax rates on income from business would further discourage new-equity-financed investment and further subsidise debt-financed investment, thereby increasing the debt–equity bias. It would also exacerbate the bias against risk-taking, the lock-in effect and (if applied to shareholder income) the incentive to shelter funds within a company.

- Increasing tax rates on profits from self-employment would further increase the bias towards the incorporated over unincorporated legal form. Conversely, if dividend and capital gains taxes were increased by enough, self-employment could become the tax-favoured legal form.
- Reducing taxes on employment would have no downside in terms of distortions (and it would lessen the incentive to operate through a business). But aligning rates by reducing employment taxes would be very expensive.

## 4.2 Packages: why and how

A key benefit of the overall ‘big-picture’ solution is that it solves many problems at once. In doing so, it largely removes the trade-offs listed above. Short of implementing the full solution, however, some of the trade-offs can be lessened by combining some policy reforms together. Several tax rates can be adjusted together with a view to ensuring that we do not simply reduce the incentive to move into self-employment but increase the incentive to incorporate, for example. And changes to the tax base can be made alongside increases in tax rates in order to mitigate the extent to which higher tax rates worsen existing distortions in the tax base. This approach cannot remove all trade-offs, but can make some less sharp. In Chapter 5, we discuss example packages, many of which aim to lessen trade-offs in this way.

In choosing which reforms to enact, and which to group together, there are other issues that policymakers will likely want to consider.

One – perhaps surprising – factor to consider in plotting tax base reform is the likely path of interest rates. As we highlighted in Section 2.2, many distortions within the tax base are larger when interest rates are higher. At the moment (with historically low interest rates), the benefits of reforming some parts of the tax base are smaller; the flip side is that the exchequer cost of fixing those parts would also be smaller. If interest rates are expected to be low for the next few years but rise some time later, there is a case for introducing reforms now rather than waiting, so that they can be implemented, tested and bedded down while they are relatively inexpensive to the government and the costs/risks associated with any glitches are lower for taxpayers and the exchequer. In so far as interest rates are expected to remain low in the longer term, that should shift the balance of priorities towards fixing those parts of the system that are not less problematic at lower interest rates –

specifically, towards aligning tax rates, making loss offsets more flexible and ending CGT uplift at death – with other aspects of tax base reform given lower priority.

A second factor to consider is the revenue and distributional consequences of any moves. If the ‘big-picture’ solution were implemented, it could be done in a way that was revenue-neutral. It could not be done without creating losers. The same holds for smaller packages. It would be possible to do these in ways that were revenue-neutral, if that were desired. Some of the individual measures (such as the introduction of an RRA or ACE) cannot easily be adjusted to affect the revenue cost. In such cases, a revenue-neutral package would require revenue adjustment to come through other measures, such as through changing tax rates. But, however packages were chosen and implemented, they would have distributional effects. Overall, for business owner-managers, the big-picture solution mostly entails a more generous tax base and higher tax rates on income from business. Broadly, those business owners making mostly normal returns to capital would see a cut in their taxes whereas those making large excess returns to capital invested – including those who are effectively only generating labour income and taking it in the form of self-employment income, dividends or capital gains – would see higher taxes (because they would lose more from any increase in tax rates than they gained from a more generous tax base). Most of the possible packages that could be created by combining rate and base adjustments would share these distributional features. Employees and employers would gain from any tax rate alignment measures that reduced tax rates on employment rather than (or as well as) increasing tax rates on income from business.

In choosing packages, it will often make sense to pair giveaways with takeaways, even if the overall package is not intended to be revenue-neutral. More specifically, it would be better not to enact or even announce giveaways first and try to enact takeaways later. The goodwill and leverage that giveaways can buy should be used sparingly. In 2016, the move to a single-tier state pension equalised the treatment of employees and the self-employed for future state pension accrual: both groups now accrue the same rights to the same state pension. Doing so led to a significant increase in the generosity of state pensions for the self-employed (see Crawford and Tetlow (2016)). At the time, there was no adjustment in the rates of tax for the self-employed. A year later, in 2017, the government tried and failed to increase the main rate of NICs for the self-employed from 9% to 11%. Even though this was a

smaller takeaway than the previous giveaway, the move was opposed and the government U-turned. Arguably, by leaving a year's gap rather than linking the two reforms together, the government squandered an opportunity to reduce the gap between the tax treatment of the self-employed and employees. It should not make the same mistake again.

## 5. Example reform packages

In this chapter, we present some examples of possible reform packages that combine elements of the ‘big-picture solution’ set out in Chapter 3 in ways that arguably move the tax system in the right direction and illustrate the trade-offs involved. Table 5.1 provides a summary of the example packages; we then discuss each in turn (in varying degrees of detail). These are not exhaustive; there are many ways that policies could be combined. And, as we highlighted in Chapter 4, there are plenty of bad policy options, but no one ‘right’ or ‘best’ package; each involves trade-offs.

Packages 1–5 set out options for adjusting tax rates without changing the tax base. These could be implemented in isolation as ways of better aligning rates across (at least two) legal forms. However, as we highlighted in Chapter 4, increasing tax rates on income from business without reforming the tax base would worsen the distortions that arise as a result of the current tax base. Packages 6–9 are examples of combining rate increases with changes to the tax base in ways that mitigate some of the distortions. Packages 10 and 11 set out other possible policy combinations, highlighting how unfortunate anomalies in the current tax system could be addressed in combination with reforms in related areas of policy.

## Key findings

- 1 There are many possible combinations of tax rate changes that would bring the taxation of different forms of income into closer alignment. This could include reducing tax rates on employment as well as increasing tax rates on income from business.
- 2 Increasing tax rates on business income in isolation would worsen distortions created by the tax base. Packages that combine rate increases with tax base reforms can mitigate such concerns.
- 3 For example, higher tax rates could be combined with more generous treatment of investment costs or losses at the personal or corporate level, supporting investment and risk-taking – genuine entrepreneurial activity – rather than activity that happens to be done in a particular legal form.
- 4 Reforms to this part of the tax system could be combined with reforms to other policies in related areas. For example, higher tax rates for the self-employed could be linked to improved access to state benefits; the treatment of capital gains at death could be considered alongside inheritance tax and the funding of social care for the elderly.



Table 5.1. Example packages

Combinations of rate changes	
1.	Reduce employer NICs; increase employee and self-employed NICs
2.	Levy NICs (or equivalent tax) on dividends (and perhaps other taxable capital income) in exchange for reducing NICs rates
3.	Increase income tax (including on dividends) and CGT; reduce NICs
4.	Align tax rates on capital gains with those on capital income
5.	Remove big separate allowances for dividends and capital gains
Combinations of higher rates and a narrower base	
6.	Increase headline tax rates in return for broadening the annual investment allowance
7.	Increase dividend tax and CGT rates and introduce a new investment vehicle offering income tax relief for investment, with tax on withdrawal of funds instead
8.	Increase headline tax rates and allow losses to be offset more flexibly
9.	Increase CGT and dividend tax rates and reintroduce inflation indexation
Other combinations	
10.	Increase self-employed NICs in return for greater access to state benefits
11.	Remove CGT uplift at death, in conjunction with reforms in other policy areas, such as inheritance tax

## 5.1 Packages of tax rate changes with no reform of the base

This section discusses packages that would adjust tax rates only. This may be appealing because rate differences are the main source of the most obvious problem with the current system, the big differentials in taxation of different legal forms. However, and as highlighted earlier in the report, a key trade-off with this approach (and therefore with example packages 1–5) is that increases in tax rates worsen existing distortions in the tax base. While the tax base distortions may not be the most problematic parts of the tax system at the moment, the problems would be much larger at higher tax rates.

The biggest contributor to the tax differential across legal forms is employer NICs. If a firm (or a household) employs someone to do some work, it must pay 13.8% NICs; if it gets the work done by a company or self-employed contractor instead, it does not. That leads to more work being done via self-employment or incorporation rather than employment. In order to remove the bias towards self-employment that is created by differential NICs rates, there would need to be alignment between the rate of NICs charged on self-employment incomes (the main rate is 9%) and the combined rate of employee and employer NICs charged on employment income (main combined rate is 22.7%).<sup>85</sup> Raising self-employed NICs to match employee NICs (main rate 12%) would leave most of the distortion in place; policymakers should absolutely avoid increasing the Class 4 rate to 12% and presenting that as a final solution. The main rate of self-employed NICs could simply be moved above the main rate of employee NICs; there are other countries (such as the US) in which the rate of social security contributions charged to the self-employed is higher than the rate charged directly to employees. However, this may be thought politically difficult in the UK. Our first package, discussed in more detail below, therefore discusses a combination of increases in employee and self-employed NICs and a cut to employer NICs that could bring the taxation of employees and the self-employed closer together.

<sup>85</sup> As discussed in Section 2.2, there is no principled reason why the self-employed should not face an equivalent charge to employer *and* employee NICs.

Of course, increasing tax rates for the self-employed would increase the incentive for them to incorporate. Levying NICs (or an equivalent) on dividends and capital gains (example package 2) would aid alignment across all legal forms.

Increasing NICs on self-employment income or applying it to shareholders' income in order to reflect the absence of employer NICs would be controversial in the UK. Many do not see why business owners should pay an equivalent tax (the answer being that employer NICs are part of the tax on work that should apply equally across all legal forms; the self-employed are in effect their own employer). One alternative idea that has attracted the support of some groups is for a new 'engager NICs' that would be levied on the person buying the services of the self-employed or company owner-managers. In some ways, this is a more natural response than getting self-employed individuals or company owner-managers to pay more tax than an employee would (for example, making the self-employed themselves pay the equivalent of employer as well as employee NICs). It has the appeal of sounding more equivalent to employer NICs. But there are some serious drawbacks to this approach; we set these out in Box 5.1. Engager NICs would imply another boundary in the tax system, raising many of the same concerns that are present at the current boundary between employees and the self-employed, and would create serious difficulties for the deduction of business costs. It is also not clear that an engager NICs would overcome the political opposition: not only might firms be unhappy about the extra costs being imposed directly on them, but many of the self-employed might still (rightly) perceive that this was a higher tax on their incomes.

Given the difficulty of raising NICs (or imposing an equivalent tax) on income from business, an alternative is to cut NICs on employment and increase other taxes that already apply to business incomes. Package 3, on which we expand below, is an example of this approach.

Packages 4 and 5 set aside the NICs differences between different legal forms and discuss other ways to reduce the disparities in overall tax rates: by aligning tax rates on capital gains with those on capital income, and by removing the large separate allowances currently available for different income sources.

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**Box 5.1. Engager NICs**

One way to remove the tax differentials caused by employer NICs would be to require firms engaging an external contractor to pay an equivalent to employer NICs on the contractor's fee, as they would if they were employing the worker directly. This idea is sometimes called 'engager NICs'. Economic theory suggests that, in the long run, it should make little difference whether the tax is paid by the engager or the contractor: the laws of supply and demand mean that the fee should adjust to leave the engager's tax-inclusive costs and the contractor's after-tax income the same in either case. In the short run, the choice would make a difference, however; and presentationally it might be easier to justify engager NICs than a big overt tax rise for business owner-managers.

Unfortunately, there are two major downsides to engager NICs. One is which contractors, and which engagers, it would apply to. The other is how to deduct costs from the tax base. To see the issues, consider a simple case of a firm hiring a cleaner. The person doing the cleaning might be employed by the firm, self-employed, working through her own company or employed by a cleaning company. Only in the first of these cases would the firm pay employer NICs, though in the last case the cleaning company would pay employer NICs on the cleaner's salary. In which of these cases should the firm have to pay engager NICs? If engager NICs were payable on contracts with the self-employed but not personal service companies, the problematic boundary merely shifts; we would see incorporation rather than self-employment in order to escape the tax. We could charge engager NICs on payments to personal service companies as well. But it is hard to see how they could be charged on payments to a cleaner's personal service company without also being charged on payments to a separate cleaning company. The firm paying a company for cleaning services has no way of knowing whether or not it is the cleaner's own company; and more fundamentally, there is no clear underlying distinction between the two. Someone might set up their own cleaning company and hire one other person. Would engager NICs be payable then? Wherever a line was drawn – based on legal form, turnover, whether the cleaning business had any employees (or how many) or some other criterion – it would simply shift the current unfairness, distortions and complexity to that new boundary. The only way to avoid it would be to apply engager NICs in all of these cases, including payments to a (potentially large) cleaning company. In that case, the firm would presumably have to pay engager NICs on all of its payments to suppliers: not only cleaning but consultancy, security, software, catering, refurbishment, machinery or whatever else it used. Advocates of engager NICs are probably not envisaging firms' having to pay it when they buy new computers or desks, but that is the only way to avoid merely shifting the problematic boundary. In contrast,

increasing tax rates on business income would automatically apply equally whether the business income was received by a sole trader or a giant company, without needing every customer to pay a new tax for using the business's services.

The idea of charging engager NICs even on payments to larger service providers highlights the second challenge for the policy: how to allow deduction of business costs. If engager NICs were charged on the fees paid to a cleaning company, the cleaning company's wage costs would first have to be deducted from the fees, or we would in effect end up with both engager NICs *and* employer NICs being paid on the cleaner's salary. And the cleaning company might also have to pay for other things – anything from cleaning products to an office, a computer, a website, advertising, accountancy, insurance, etc. – all of which should be deductible from the fees on which engager NICs are charged, as is normal with business expenses: taxing turnover rather than profit would be hugely distortionary. But if the cleaning company has multiple clients, how much of these central costs should each client deduct from their contractual payments before calculating the engager NICs due? These issues rarely arise for employer NICs – employees rarely have significant deductible expenses, and it is even rarer that they would not be specific to a particular job – but for businesses supplying services they are common. The problem is obvious in the case of a big cleaning company, but even if the cleaner is a one-man band, he might still provide his own cleaning equipment and products, buy a car or van to get to clients' workplaces, and pay an accountant to do his books – costs that would be difficult to apportion between clients and deduct in their respective engager NICs calculations. An engager NICs looks much less appealing when the contractor needs inputs beyond his own labour to provide the service.

Finally, we should ask what kinds of engager, as well as what kinds of contractor, would be within the scope of engager NICs. If it were an individual, rather than a firm, hiring a cleaner, would she be obliged to pay engager NICs to HMRC on the cleaner's fee? Individuals can sometimes be required to operate PAYE and remit tax – for example, if they hire a nanny – but requiring them to remit tax every time they use a cleaner (or plumber, or taxi, ...) is clearly unrealistic. Yet if engager NICs applied only to *business* engagers, it would leave the tax differential unaddressed for those providing services to households, and add yet another unfortunate distinction into the system. The obvious solution would be for the cleaner (or cleaning company) to account for the tax across all clients, and perhaps charge clients extra to cover it (as they do with VAT, if registered). That returns us to the option of increasing tax rates on incomes from business (i.e. the other ideas in this report) rather than 'making the engager pay'. The only difference is whether we label the extra tax on their income as being paid on behalf of the engager.

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## Package 1: reduce employer NICs and increase employee and self-employed NICs

Employer NICs represent the majority of the tax differential between employment income and business income. Reducing employer NICs in isolation would be expensive, but it could be combined – in a revenue-neutral way if desired – with increases to self-employed and employee NICs. Increasing employee NICs alongside self-employed NICs would mean the self-employed would be less likely to be seen as being singled out for tax increases, even though the overall tax wedge on employment might not change much. And increasing employee NICs would create more scope to increase self-employed NICs without raising them above employee NICs.

The government's latest estimates of the revenue effects of changing rates of NICs are as follows:<sup>86</sup>

- a 1 percentage point (ppt) cut in employer NICs would cost £6.6 billion;
- a 1 ppt increase in the main (additional) rate of employee NICs would raise £4.5 billion (£1.1 billion);
- a 1 ppt increase in the main (additional) rate of self-employed NICs would raise £0.40 billion (£0.24 billion).

So for illustration, aligning employee and self-employed NICs main rates and raising both to 14% would raise almost £11 billion; raising both additional rates from 2% to 5% would raise £4 billion; together these changes could finance a cut in employer NICs from 13.8% to 11.6%. This would make the new combined main rate for employees 22.9%, almost unchanged relative to the current rate (22.7%), but the rate for the self-employed (14%, up from 9%) would now be closer to it.

## Package 2: levy NICs (or equivalent tax) on dividends (and perhaps other taxable capital income) in exchange for reducing NICs rates

After accounting for corporation tax, dividends are taxed more heavily than self-employment income, much more heavily than capital gains, and not far short of

<sup>86</sup> Estimates as of May 2020 and for the year 2021–22, but without taking any account of the effects of COVID-19 or policies introduced in response since the March 2020 Budget. Source: <https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes>.

earnings, at the higher rate. But at the basic rate, dividends are taxed less heavily than any of those. And it is for basic-rate taxpayers that employee NICs rates are high. Extending employee NICs (or applying an equivalent) to dividends would therefore be quite well suited to closer rate alignment.

Increasing tax rates on dividends by employee NICs rates would mean a 12 percentage point increase in the basic rate of tax on dividends (taking it from 7.5% to 19.5%) and a 2 percentage point increase in the higher and additional rates (taking them from 32.5% to 34.5% and from 38.1% to 40.1% respectively). The revenue could be used to reduce employee or employer NICs rates, further reducing the disparity between tax rates on employment and income from business and strengthening work incentives.

A downside is that increasing the tax rate on dividends but not capital gains would increase the incentive for company owner-managers to keep money in their company to take as capital gains rather than take it out as dividends, and favour those who were able to do so (because they did not need the money to spend in the short term). It would also make self-employment more attractive for some business owners. And without reform of the tax base, it would weaken the incentive to invest in shares, raising the cost to companies of issuing new equity and correspondingly increasing the bias towards using retained earnings or debt.

A rise in dividend taxation would not just affect the UK's 2 million company owner-managers. Many other UK residents also receive dividends (other than through a pension, ISA or other tax-free vehicle); they include, for example, those who acquired shares during the 1980s wave of privatisations and the demutualisation of building societies. Other than company owner-managers, those with dividend income will be disproportionately pensioners.

To give a sense of scale: overall, in 2017–18 (the latest year for which the government has published statistics), 4.6 million UK taxpayers received a total of £65.5 billion of (potentially taxable) dividend income: an average of £14,300 each. Three-quarters of them had income below £50,000 (now the higher-rate threshold), but they accounted for less than 40% of the aggregate dividend income.<sup>87</sup> However, the £2,000 dividend allowance means that those whose dividend income is below

<sup>87</sup> Source: authors' calculations based on table 3.7 of HMRC Statistics, <https://www.gov.uk/government/statistics/investment-income-2010-to-2011>.

£2,000 will not pay any tax on it (the number actually paying tax on dividends is not published but will be far lower than 4.6 million) and those with dividends above that level will pay less than if there were no allowance. The people who pay tax on dividends despite the presence of the dividend allowance will disproportionately be company owner-managers, since they are more likely to receive a large fraction of their income in dividends and exceed the £2,000 dividend allowance.

Charging employee NICs rates on all dividend income (in addition to existing taxes) would raise about £4 billion a year (before allowing for any behavioural response to the change), roughly three-quarters of it from basic-rate taxpayers. However, if the change were implemented by simply increasing existing tax rates on dividends, the dividend allowance would shield much of the dividend income from the tax rise, making it a much smaller and more progressive tax rise and much more focused on company owner-managers. From publicly available data, it is not possible to quantify how many people would pay how much more tax in that case. But a quick comparison with the cost of reducing employee or employer NICs given above (£5.6 billion and £6.6 billion respectively per percentage point) shows that increasing dividend taxes would not ‘buy’ much reduction in employment taxes: the sheer quantity of employment income makes cutting employment taxes very expensive.

### Package 3: increase income tax and CGT and reduce NICs

The broad aim of this package is to reduce the gap between taxes on earnings and taxes on capital income by adjusting rates of NICs, income tax and CGT. Since both income tax and NICs apply to earnings while income tax also applies to dividends and CGT to capital gains, shifting from NICs to income tax and CGT could leave the tax rate on earnings unchanged while increasing tax on income from business. There are various ways to do this.

One option would be to increase income tax and CGT and reduce employee NICs by the same number of percentage points. This would leave employees who have stable earnings and no other taxable income no better or worse off, while increasing tax on those with dividend income and capital gains, notably company owner-managers, and reducing the incentive to incorporate. If self-employed NICs were reduced as well as employee NICs, then the self-employed would also be no better or worse off (reducing the incentive for the self-employed to incorporate, but not the incentive to be self-employed rather than employed); if only employee NICs



were reduced, the self-employed would lose in the same way as company owner-managers (reducing the incentive to be self-employed rather than employed, but not the incentive for the self-employed to incorporate). Since the employed/self-employed discrepancy is much bigger than the unincorporated/incorporated discrepancy, limiting the NICs reduction to employees would reduce overall distortions more.

Alternatively, reducing each of employee, employer and self-employed NICs by (say) 2 percentage points and increasing income tax and CGT rates by 4 percentage points would increase tax by 4 percentage points for company owner-managers (who are most tax-favoured at the moment) and by 2 percentage points for the self-employed, while leaving the overall tax burden on employment largely unchanged – a good balance of adjustments. But, as with package 1, the shift from taxing employers to taxing employees might be politically difficult, and employees would lose out in the short term as it would take time for salaries to rise in response to the tax change. Preannouncing the change would help this wage adjustment to happen sooner, but would also give an opportunity to pay dividends or realise capital gains before the tax rise took effect.

Rather than increasing income tax and CGT and reducing NICs symmetrically, the government could do it in a way that made the system more progressive by focusing NICs reductions on lower earnings and focusing income tax and CGT rises on higher incomes. For example, the reductions in NICs could apply only to the main rate, but all rates of income tax and CGT could be increased. The employee NICs rate above the upper earnings limit (UEL) is only 2% anyway, so that is the most it could be reduced. Any option that involved doing that would return us to a system where employee NICs are capped at the UEL (as they were before 2003), a slight simplification.

The treatment of dividends is not the only difference between the income tax and NICs bases. The reform would therefore also affect others:

- It would increase tax on pension income and on the earnings of those above state pension age (which would make the package more attractive to some and less attractive to others).
- It would reduce the huge and unjustifiable subsidy for employer pension contributions that the NICs system currently provides.

- Among employees, income tax is levied on total annual income whereas NICs are assessed separately for each pay period and with a separate threshold for each job, so shifting from NICs to income tax would reduce tax for modest earners with volatile earnings and increase it for high earners with volatile earnings and for those with more than one job. Making tax liabilities more closely related to total annual earnings in this way would be another improvement, albeit one with losers.

### Package 4: align tax rates on capital gains with those on capital income

It is hard to understand why capital gains on shares should be taxed more than dividends at the basic rate but less than dividends at the higher rate; or why ordinary income and dividends are subject to basic, higher and additional rates of tax while capital gains are subject only to basic and higher (no additional) rates. Taxing capital gains at the same rates as capital income would rationalise the system and move closer towards overall alignment.

CGT rates would be lower for shares than for other assets – just like dividends are taxed at lower rates than other income – to reflect corporation tax already paid. This is more logical and defensible than the current system where CGT rates depend on the ownership of the business rather than whether corporation tax has already been paid (and are arbitrarily higher for second and rental homes). It is also simpler and easier to explain.

The basic, higher and additional rates of CGT would be 7.5%, 32.5% and 38.1% respectively for shares (matching dividend tax rates) and 20%, 40% and 45% respectively for other assets (matching capital income tax rates). This would be a reduction in the CGT rate on shares for basic-rate taxpayers, and an increase in the rate for other assets and other taxpayers. Shares account for about two-thirds of the £60 billion capital gains realised each year in the UK. And of the quarter of a million people who pay CGT each year, the majority are basic-rate income taxpayers (though their capital gains might push them into a higher bracket, in which case only some of their gains would be taxable at the basic rate).<sup>88</sup> But the tax cut for basic-rate taxpayers would typically be much smaller than the tax rise for

<sup>88</sup> Source: authors' calculations from tables 3 and 7 of HMRC Capital Gains Tax Statistics, <https://www.gov.uk/government/statistics/capital-gains-tax-statistical-tables>.

higher-rate taxpayers, who tend to make bigger gains and who would see their tax rate increase by more than basic-rate taxpayers saw it fall.

Since this is predominantly a tax rate rise, on its own (without reform of the tax base) it would weaken incentives for investment and entrepreneurship. On the other hand, it stops short of full alignment of tax rates across legal forms (particularly at the basic rate), which would need to take account of NICs as well as corporation tax. In the absence of serious reform of the tax base, this rationalisation of tax rates might be a reasonable and defensible compromise.

### Package 5: remove big separate allowances for dividends and capital gains

People who can divide their income between earnings, dividends and capital gains (including company owner-managers) can receive up to £26,800 per year tax-free (£12,500 income tax personal allowance, £12,300 CGT annual exempt amount and £2,000 dividend allowance), compared with an income tax allowance of £12,500 for those who receive only ordinary income. It would be fairer simply to tax people on their total income, regardless of the form it took, and would remove one of the tax advantages of operating through a business rather than employment. To achieve this, the separate allowances could essentially be merged, with a single allowance available to set against any source of income or capital gains. If the revenue raised from removing separate allowances were used to increase the size of the allowance (or, better, the NICs threshold) a little, there would be no overall detrimental effect on work incentives, just a levelling of the playing field.

There is a case for keeping a separate *de minimis* CGT annual exempt amount (AEA) for administrative reasons, so that people making small capital gains (for example, on small shareholdings they own through an employee share scheme or from past privatisations/demutualisations) do not need to fill in a tax return; but that would be nowhere near the current £12,300 level. There is clearly a trade-off between economic advantages and administrative burdens here. HMRC estimates that (Office of Tax Simplification, 2020, para. 4.15):

- Reducing the AEA to £6,000 would raise an additional £480 million of revenue in 2021–22 and result in 235,000 more people needing to report a capital gain (96,000 of whom already file income tax self-assessment returns).

- Reducing it to £2,500 would raise an additional £835 million and result in 360,000 more people needing to report a capital gain (120,000 of whom already file income tax self-assessment returns).

These estimates are before behavioural response; in practice, the number of additional taxpayers would be lower as people kept realisations below the new allowance. There is a huge spike in the number of people reporting capital gains just below the AEA, showing that people do plan their capital gains realisations to make the most of the AEA.<sup>89</sup>

## 5.2 Packages with higher rates and a less distortionary base

If tax rates on capital income were increased (with a view to greater alignment) in ways such as those described above, the distortions present in the tax base would be made worse. Here we expand on three packages that would combine capital tax rate increases with moves to alleviate the distortions in the capital tax base.

Often, lower tax rates for business owners are defended as a means to promote entrepreneurship and investment. Even if this is the goal (and we discuss in Section 2.3 when we might want to encourage – rather than not discourage – activities), lower rates are poorly targeted at achieving it. Much of the tax break will go to successful projects that would have happened absent any tax break, or to businesses that are not entrepreneurial. Moreover – and perhaps ironically – those people who are making investments, taking on risks and facing the possibility of making losses are discouraged by the tax system. The packages we set out below – which address these issues – would encourage genuine entrepreneurship by recalibrating the tax system away from tax breaks for certain legal forms towards specific measures targeted at investment and risk-taking.

### Package 6: increase headline tax rates in return for broadening the annual investment allowance (AIA)

Increasing tax rates on self-employment income, dividends and capital gains (or corporation tax) would move closer to alignment across legal forms but would also

<sup>89</sup> In 2017–18, 52,000 taxpayers declared capital gains in the £1,000 window below the AEA, half of them just in the £100 window below it. See Office of Tax Simplification (2020, 120).

reduce incentives for equity-financed investment. That could be offset overall by allowing more investment to be tax-deductible at the point it is incurred. One way to do this would be to extend the AIA to investments that it does not currently cover.

There are many assets currently outside the scope of the AIA (see Chapter 2), though many of them are used more widely by big businesses than by the small ones that are the subject of this report. Short of extending the AIA to all investments (which would be ideal), the government could choose particular asset types which could be brought within its scope.

One example is training, which is currently deductible only if paid for by an employer or, for the self-employed, if it is to refresh existing skills rather than learn new ones. Allowing a wider range of training costs to be tax-deductible would remove the tax disincentive to invest in training – particularly valuable given the economic dislocation caused by COVID-19, which will require many people to (re)train for different jobs. But care would be needed to ensure that relief was not given for ‘training’ that was really just a hobby.<sup>90</sup>

Another example is cars, which currently attract 100% first-year allowances only if they are in the lowest emission bands. Bringing cars within the AIA would remove the disincentive to buy cars to use in a business. But while higher capital allowances for lower-emission cars are a poorly designed way to reduce emissions from motoring – there is no reason incentives to reduce emissions should be focused more on cars bought for business use – increasing capital allowances for high-emission cars would need to be accompanied by other, better-designed, measures to reduce emissions (for example, through fuel duties, vehicle excise duty or a scrappage scheme) to avoid creating higher emissions (and more congestion) overall.<sup>91</sup>

Increasing tax rates on business income while broadening the AIA would strengthen incentives to invest in the assets concerned, removing the penalty for equity-financed investment and increasing the subsidy for debt-financed investment

<sup>90</sup> This was one of the major – and reasonable – concerns raised in the government’s 2018 consultation on the subject (<https://www.gov.uk/government/consultations/taxation-of-self-funded-work-related-training>), which decided against extending tax relief for training, though the analysis left something to be desired.

<sup>91</sup> See Adam and Stroud (2019) for a discussion.

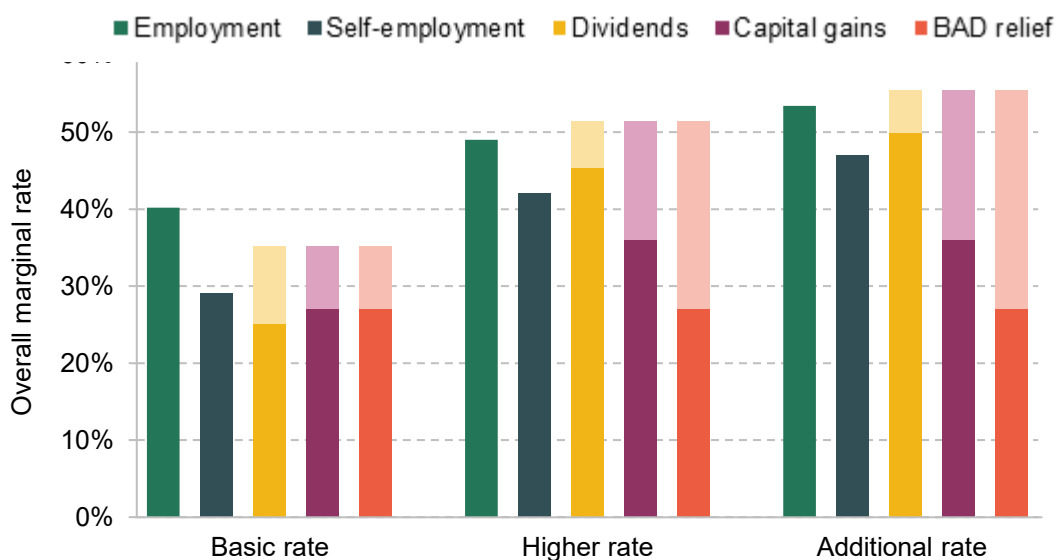
in them. It would have little effect on incentives for equity-financed investment in assets already within the AIA, while the higher tax rates would weaken incentives for equity-financed investment in assets that remained outside the AIA; incentives for debt-financed investment would be strengthened for all assets. If done in a revenue-neutral way, it would strengthen investment incentives overall. But it would also increase the overall bias towards debt rather than equity finance. The increased capital allowances for investments brought within the AIA would provide similar encouragement whether the investment was debt- or equity-financed, whereas the higher tax rate would increase the bias towards debt finance for other assets (both those already covered by the AIA and those still left outside it).

### **Package 7: increase dividend tax and CGT rates and introduce a new Personal Shareholding Account**

A central reason for tax-motivated incorporation is that money taken as dividends or (especially) capital gains is taxed at much lower rates than earnings. But a central problem with increasing tax rates on dividends or capital gains is that it would reduce the incentive for people to buy shares and make it harder for businesses to raise finance for investment.

A reform that would address this directly is to increase tax rates on dividends and capital gains while at the same time introducing a new investment vehicle – which we will refer to as a Personal Shareholding Account (PSA) – through which people could buy new equity in a tax-neutral way. This would mean equity-financed investment was discouraged less than at present (indeed, not discouraged at all by personal taxation) despite the higher headline tax rates.

For illustration, the government could tax dividends and capital gains (crucially including those currently subject to BAD relief) at ordinary income tax rates: 20%, 40% and 45% in the basic, higher and additional tax bands respectively. This would move us far closer to alignment of overall tax rates across legal forms, as shown in Figure 5.1. And simply taxing dividends and capital gains at ordinary income tax rates would be relatively straightforward to explain and motivate.

**Figure 5.1. Illustration: taxing dividends and capital gains at income tax rates**

Note: Tax rates on employment and self-employment are inclusive of all NICs; tax rates on dividends and capital gains are inclusive of corporation tax. Lighter coloured segments of the bars show the proposed reform; the darker segments are the same as in Figure 2.1.

But the government could increase tax rates less radically if it preferred; or (ideally) it could set rates to achieve alignment more precisely overall, taking into account the corporation tax also paid on company profits and the NICs also paid on earnings (see Section 3.2).

The PSA would be a new vehicle which people could use to buy new equity issued with a cash-flow personal tax treatment as described in Section 3.3. Individuals would receive up-front income tax relief on any money they put into a PSA. Money in the PSA could be used to buy new equity issued by companies, and any dividends or capital gains received within the PSA would not be taxed. But any money the individual withdrew from the PSA would be subject to income tax at that point. That is identical to the current income tax treatment of pensions, except that there would be no 25% tax-free lump sum. The PSA could also be likened to an ISA or an EIS/SEIS/VCT. Unlike any current vehicles, however, it would be available – indeed, intended – for people to invest in their own company (or that of a connected person), not just for arm’s-length shareholders. In that respect, it could also be thought of as a replacement for BAD relief. Importantly, the PSA would be better targeted: it would be available to business owners making new investments at the point they invest and in proportion to the amount they invest, rather than

available to all business owners regardless of investment, only many years in the future, and worth more to those who make the most money.

If it wanted to, the government could impose additional restrictions on PSAs, such as:

- limiting eligible investments to shares in unlisted companies (like the EIS, SEIS and VCT do);
- imposing a cap on the amount that could be invested (as pensions, ISAs and EIS/SEIS/VCT all do). The cap could be on annual or lifetime contributions to the PSA, and could be gross or net of withdrawals.

In principle, there is no need for restrictions such as these: the PSA would be well suited to portfolio investment in the stock market, and since it offers neutral rather than subsidised treatment (with excess returns taxed in full) there seems little reason to limit the investments. Keeping the availability of the scheme as wide as possible would maximise the economic benefits and help to make the scheme better known. But if the government wanted to ‘test the water’, or were concerned about the potential size of up-front tax relief (although it would get correspondingly more revenue later from taxing withdrawals), then having such restrictions, at least initially, could provide some reassurance.<sup>92</sup>

A PSA would be simpler than a pension or an EIS/SEIS/VCT, though not as simple as an ISA. It could be explained and marketed as a new kind of ISA (a tax-deferred ISA) or a new kind of EIS, or as analogous to a pension.

As explained in Section 3.3, this treatment would remove disincentives to invest even while increasing tax rates on excess returns and reducing incentives for incorporation and income-shifting.

### Existing schemes and going beyond neutrality

The PSA would be a natural replacement for, and improvement on, BAD relief, but it could also replace investors’ relief and venture capital schemes (EIS, SEIS, VCT and SITR). It is designed to achieve neutrality and avoid penalising investment. If

<sup>92</sup> We would advise against a minimum holding period (as for EIS/SEIS/VCT) or a ‘risk-to-capital’ test (as recently introduced for EIS/SEIS). Again, such restrictions are unnecessary for a system that is neutral rather than subsidised; and unlike the restrictions mentioned in the text, these would be actively distortionary rather than merely limiting the scope of the schemes.



the government wanted, for whatever reason (presumably correcting some market failure), to go beyond neutrality and actively encourage investment, it could create a variant of the PSA which provided relief for contributions at more than the taxpayer's marginal income tax rate (for example, provide relief at the taxpayer's marginal rate plus 10 percentage points, or add a 10% top-up to PSA contributions as well as giving tax relief at the marginal rate).

Existing venture capital schemes (EIS, SEIS, VCT and SITR) go beyond neutrality, but do so through a mixture of well and badly targeted provisions. The up-front income tax relief they provide for investments is well targeted. But the CGT exemption on returns is not, providing the most generous support for investments that earn the highest returns and therefore incurring unnecessary deadweight cost as the highest-return investments are the ones that are likeliest to go ahead regardless of tax support. The PSA would provide the up-front income tax relief on investment without the CGT relief on returns; if the government wanted to go beyond neutrality, it should simply provide even more income tax relief up front (as it did when introducing the SEIS, which attracts 50% income tax relief rather than the 30% available through EIS and VCT).

If the government did introduce a subsidised version of the PSA, then it should be subject to strict limitations (in a way that is not needed for the neutral PSA) in order to target the subsidy precisely at the market failure and prevent (or at least minimise) abuse aimed at capturing the subsidy. Whether the restrictions currently used for venture capital schemes – connected-person exclusions, restrictions to unlisted trading companies, caps on investments, minimum holding periods and risk-to-capital tests – are the right set of restrictions depends on exactly what market failure the government is trying to address. We do not consider that further here.

### Winners & losers and existing shares

Winners from a reform that raised tax rates and introduced a PSA would be those making a normal return from investing in a company, who would no longer be taxed for doing so.

Losers from the reform would include not only those whose future business profits exceed a normal return to capital invested (most obviously if it reflects their labour as well as capital) but also those holding shares in a taxable form outside a PSA.

Shares outside a PSA (or pension or ISA) would be subject to the higher tax rates without getting the extra relief. Primarily, this would mean existing taxed shares (if the PSA is available only for new shares issued), any shares excluded by restrictions the government sets on PSAs and any shares that investors choose to purchase outside the PSA.

Those who had invested in the past, or worked to build up the value of their company, in the expectation of receiving BAD relief or some other low tax rate when they came to receive the profits as dividends or capital gains are likely to feel particularly aggrieved at the withdrawal of these low tax rates.<sup>93</sup>

Since only new equity issued and bought through a PSA would qualify for cash-flow treatment, there would be an incentive to finance investment by issuing new equity rather than by retaining profits. Companies might distribute profits as dividends and then issue new shares, or repurchase existing shares and issue new ones – in effect transforming ‘old’ equity into ‘new’ equity. It is difficult to ensure that investment notionally financed by issuing new equity is really additional to the investment a company would otherwise have done. This would not be unique to PSAs: venture capital schemes also attract income tax relief only for investments in newly issued equity, though the fact that those must be arm’s-length investments means that more coordination is needed between the company and its investors than would be needed under a PSA.

There are several ways the government could respond to this incentive:

- use anti-avoidance rules to try to prevent such behaviour;
- accept it;

<sup>93</sup> This could be avoided by applying the higher tax rates only to shares held within a PSA. The PSA would still provide a viable route for marginal investments that are currently made unviable by tax, and this might be an option as a stand-alone reform to address investment disincentives. But those whose business income was a return to labour rather than capital simply would not use the PSA and would continue to face low tax rates on their income, defeating the other purpose of the reform which was our starting point for this report – and virtually guaranteeing a net cost to the exchequer, as people would use a PSA only if it meant paying less tax than under the current system.

- embrace it: do not restrict PSA investments to newly issued shares, and facilitate explicit shifting of existing shares into a PSA so that the effect could be achieved with the minimum of cumbersome transactions;<sup>94</sup> or
- remove the incentive, by adjusting the tax treatment of shares held outside PSAs.

For the last of these – if the government wanted to remove the incentive to shift existing capital into a PSA – an appropriate method would be to reform the CGT treatment of shares held outside PSAs such that, on disposal of the shares, the original acquisition cost used in the CGT calculation was stepped up with a risk-free interest rate from the time the PSA was introduced to the time of disposal.<sup>95</sup> This interest mark-up for holding on to existing shares would be exactly enough to neutralise the deduction available for crystallising profits and shifting into a PSA. If a shareholder did receive a dividend or realise a capital gain on existing shares and wanted to reinvest the proceeds, they would be better doing so through a PSA than by investing in shares outside one; but there would be no incentive deliberately to crystallise returns in that way (and pay tax now rather than later) in order to shift into a PSA.

### Smoothing taxable income

Under the PSA, taxpayers would get relief at their marginal rate when they made contributions and pay tax at their marginal rate when they withdrew their money. A consequence of this is that people whose marginal tax rate was higher when they made contributions than when they made withdrawals would receive generous relief and pay more modest tax (and, conversely, those whose tax rates rose would receive less relief and pay more tax). Higher- or additional-rate taxpayers who expected to be in a lower tax bracket in future would have an incentive to use a PSA as a way to shift their income to a lower-taxed time of their life and thus reduce their overall tax liability.

This is already a feature of pensions taxation (which, as we have noted, operates on a similar basis), with many commentators disapproving of the fact that some people receive higher-rate relief on pension contributions while paying only basic-rate tax

<sup>94</sup> Specifically: when shifting shares into a PSA, shareholders would receive a net deduction for the original acquisition cost of the shares – essentially deducting the purchase cost at that point rather than as part of a CGT calculation when the shares would otherwise have been sold.

<sup>95</sup> It is the original acquisition cost that should be stepped up: it should not be ‘rebased’ to bring it up to a more recent value as happened with indexation allowances in the past.

on their pension income in retirement. Likewise, as we discussed in Section 2.2, company owner-managers can keep money in their company, taking dividends only up to the higher-rate threshold each year and retaining any additional profits in the company until they can be withdrawn without paying higher-rate tax: Miller, Pope and Smith (2019) show that they do this on a large scale.

Introducing a PSA would extend the same opportunity to a wider range of people in a wider range of circumstances.

In general, allowing people to shift their income across years in this way is a good thing, not a bad thing. An annually assessed income tax with graduated rates penalises people whose incomes vary from year to year. Ideally, we would tax people on their average annual income (or their lifetime income), and allowing people to smooth their taxable income across years brings us closer to that.

One concern, however, is that only more sophisticated taxpayers – those who invest in shares, understand the incentives and engage in financial planning – would be likely to take advantage of this opportunity for tax-base smoothing. It is debatable whether that is a strong argument against introducing a PSA, and whether the current access to (and de facto exclusions from) smoothing opportunities is any more equitable. Rather than trying to curtail smoothing, the government could go the other way and make the PSA as simple and easily accessible as possible – for example, allowing people to save cash in it without ever investing the money in shares.

A second concern is that, whatever the rights and wrongs of tax-base smoothing, it would cost the exchequer money. If we could actually tax people on their average annual income, without the extra revenue generated by taxing people at higher rates in unusually high-income years, the appropriate counterpart would be to reduce tax thresholds: we should apply higher-rate tax from less high income levels if those incomes reflect people's genuine long-term incomes than if they merely reflect people having an unusually good year. The same applies here: the government could respond to the potential revenue loss by reducing income tax thresholds, if it wanted. Smoother tax bases and lower tax thresholds would be a net improvement to the system. But, of course, it would be up to the government if it wanted to do that. It is difficult to gauge in advance the likely magnitudes of tax-base smoothing

and revenue loss, and therefore how big an adjustment to tax thresholds would be needed to maintain revenue.

If, for either of these reasons (or others), the government disliked the idea of opening up this opportunity for tax smoothing, it could adopt an RRA rather than a cash-flow tax treatment of new equity investment. Since the RRA approach does not involve taxing and deducting flows of principal, just identifying the net excess returns, it does not involve such big additions and deductions to the tax base in different years – although there is still some scope to shift income by choosing the timing of realisations, for example, as there is at the moment.

### Other assets

Our focus in this report is on small business taxation, so we have focused on how this reform would apply to shareholders. But CGT applies to other asset-holders as well, such as landlords. The government would have to decide whether it wanted to:

- (a) allow PSAs to be used for investment in other assets such as housing as well as shares;
- (b) apply the entire reform only to shares, leading to the slightly odd – but quite feasible – situation that the CGT rate was higher on shares than on other assets despite the fact that corporation tax had already been paid on profits; or
- (c) apply the tax rate increase to all assets despite the fact that cash-flow treatment was only available for equity investment – exacerbating the disincentive to invest in those other assets.

### Package 8: increase headline tax rates and allow losses to be offset more flexibly

Risk-taking is discouraged if good outcomes are taxed more than bad outcomes are cushioned. An important reason the current tax system has that effect is because loss offsets are not symmetric to the taxation of profits/gains. Losses cannot always be offset, and when they are carried forward their present value is not maintained.

Increasing tax rates on business income would exacerbate that problem – as would measures we propose to increase deductions for investment, since those would make losses more common and bigger.

Making loss offsets more flexible and generous would mean that tax rates could be increased with less effect on discouraging risk-taking. Knowing that the government will cushion downsides (almost) as much as it taxes upsides would significantly alleviate the current disincentive to take risks. Entrepreneurs and investors who are conscious of the risks they are taking – perhaps more so than ever, after the COVID-19 outbreak – might also be more willing to accept higher tax rates if the government were also giving them greater insurance in return.

Allowing losses to be offset against profits/gains whenever possible is also fairer, bringing us closer to a situation where two people with the same overall income pay the same overall tax. A person's tax liability should be related to their ability to pay across all forms of income, adding up income and losses from all sources to arrive at an overall profit/loss. And ideally, a person's tax bill over their lifetime should be based on their total income over their lifetime, so losses in one year should be deducted from income in another year. We should aim to stop taxing someone who has a profit from one source (or year) and a loss from another more than we tax someone who has the same total income from a single, stable source.

The idea of this reform is therefore to increase headline tax rates on capital income and gains – reducing the differential between different legal forms and sources of income – while reforming the treatment of losses to make it more symmetric to the taxation of profits and gains.<sup>96</sup>

To fix ideas, we consider the following illustrative set of tax rate rises:

- self-employed NICs main rate from 9% to 12%;
- CGT rate for basic-rate taxpayers and for BAD relief and investors' relief claimants from 10% to 15%;
- dividend tax rate for basic-rate taxpayers from 7.5% to 12.5%.

The effect of these changes in moving towards closer alignment of overall tax rates across legal forms is shown in Figure 5.2. These changes are only illustrative; the government could, of course, choose different rate adjustments as it saw fit.

<sup>96</sup> This is in line with the OTS's recent review of CGT (Office of Tax Simplification, 2020), which recommended that 'If the government considers more closely aligning Capital Gains Tax and Income Tax rates it should also ... consider allowing a more flexible use of capital losses'.

**Figure 5.2. Illustration: rates increases to go alongside greater loss offsets**

Note: Tax rates on employment and self-employment are inclusive of all NICs; tax rates on dividends and capital gains are inclusive of corporation tax. Lighter coloured segments of the bars show the proposed reform; the darker segments are the same as in Figure 2.1.

At the same time, the government would reform the treatment of losses arising after the date the tax rate increases took effect, in some or all of the following ways:

- 1 **Allow carried-forward self-employment losses to be offset against any income or capital gains**, not just profits from the same trade. At present, the self-employed can set trading losses against their personal income from other sources (such as employment or investment income) in the year the losses arise. But if the losses are carried forward to a future year, they can only be offset against profits from the same trade. This change would extend the flexibility already available for in-year losses to apply to carried-forward losses as well. It is somewhat analogous to a change for corporate losses announced in Budget 2016 and implemented in April 2017, which allowed companies' carried-forward losses to be set against any profits (not just trading profits) if the company was still doing the same trade. But in the context of self-employment, it could be a powerful incentive for risky entrepreneurship. If I am considering starting a risky business, I might be put off by knowing I will be taxed on any profits I make if it is successful; I might be less put off if I also know that if my business fails I will be able to offset the losses I incur against income from my next job or business venture.

- 2 **Allow individuals and companies to offset capital losses against income (rather than capital gains) in a wider range of circumstances.** Currently, individuals and investment companies can offset losses on shares in unlisted trading companies against income (not just capital gains) in the same/previous year. This could be extended to apply to losses carried forward to future years as well. It could also be extended to apply to a wider range of assets, not just unlisted shares, and to all companies, not just investment companies. Again, being more likely to be able to offset losses should make individuals and firms more willing to make risky investments. However, **when individuals offset capital losses against income rather than capital gains, the rate of relief should be restricted to the CGT rate**, not the income tax rate: the aim is to treat upsides and downsides symmetrically, so if capital gains would be taxed less heavily than income, then capital losses should receive correspondingly less relief. There is no obvious obstacle to restricting the rate of relief in this way. It would actually be a reduction in generosity in those cases where capital losses can currently be offset against income (at present, people can set capital losses on unlisted shares against income taxed at a higher rate than the CGT rate). Of course, if the tax rates on income and capital gains were brought closer together, as we propose in this report, then this restriction would be less important.
- 3 **Allow losses to be carried back up to five years**, up from three years for early and terminal years, one year for other trading losses, zero for capital losses and zero for those using the cash basis. Again, we would like losses to be offset as flexibly as possible. It is not clear why at present capital losses cannot be carried back, when trading losses can; or why, if losses incurred in the early and final years of a business can be carried back for three years, losses incurred in other years could not be. There are probably practical limits to loss carry-back: at some point, a taxpayer's affairs for a particular year must be considered 'closed'. But since three years is already used, it would seem feasible to use it everywhere; and we do not think it would be excessive to extend that to, say, five years.
- 4 **Adjust losses for interest when they are carried forward or back.** Offsetting losses in future years is less valuable than offsetting them immediately, since the money received immediately could earn a return (or pay down interest-bearing debt) in the intervening period. To maintain the present value of losses, they should be carried forward with an interest rate (specifically, the normal rate of return) until they are utilised. Similarly, losses carried back should be



adjusted downwards for an interest rate. This change would be an increase in generosity for carried-forward losses and a reduction in generosity for carried-back losses. This would add some complexity to the system, though the complication is relatively minor. At current low interest rates, the reform would have little effect, and might not be thought worth the trouble and the extra complexity. But if interest rates rise in future, it could be more important.

For economic efficiency, these reforms need only apply to losses arising after the reform was introduced; they need not apply to losses incurred in the past (including during the COVID-19 crisis), since the aim is to affect future decision-making. Restricting these reforms to losses arising in future in this way would avoid the expensive and inefficient windfall giveaways entailed by releasing ‘trapped’ losses that could not otherwise be offset. However, the government could choose to treat losses incurred in the past more generously – in the ways described here or in other ways – if it wanted to help those who had suffered in the past or for other reasons of fairness.

The reforms would be progressive, since those making losses would see them cushioned while those making profits would see them taxed more heavily. As with other progressive reforms, one downside of these reforms is that they weaken work incentives: in so far as rates of return to capital reflect effort as well as rents and luck, the tax rate increases penalise high effort while the loss offsets cushion the consequences of low effort. So in some ways this is just another example of the trade-off between work incentives and redistribution: this package would mean greater progressivity at the cost of weaker work incentives.

The government could accept (or embrace) that shift along the incentives–redistribution trade-off. Otherwise, it could adjust the overall tax rate schedule to make it slightly less progressive, to (roughly) offset the net distributional and work incentive effects of the reform: so the system overall would have similar progressivity and similar work (dis)incentives to at present, but achieve them more efficiently, i.e. without distorting risk-taking in the process. The illustrative tax rate increases – focusing on increases in the basic rather than higher rates of tax – were chosen with this issue in mind. But the government can make its own choices on the balance between redistribution and work incentives.

Some of these changes would add complexity to the system: carrying losses forward/back with interest, restricting the tax rate at which losses can be relieved,

extending the length of carry-back (potentially more record-keeping), introducing carry-back for those claiming the cash basis. There may also need to be new/stronger anti-avoidance provisions (see below). However, for the most part, they simplify the current fearsomely complicated system, taking pressure off boundaries such as the capital/revenue divide (that is, whether a particular receipt or outlay is treated as current or capital for tax purposes – a notoriously fiendish question) and reducing the impetus for taxpayers to perform gymnastics such as choosing when they realise capital gains in order to ensure they can offset losses. We would be moving towards a system in which any loss could be set against any income in any year, which must be simpler than the morass of rules we have now.

The key challenge for these reforms is whether they would open up scope for abuse.

Loss offset provisions have in the past been used for tax avoidance and evasion, and the trend in recent decades has been for the government to tighten rather than relax loss offset rules in an effort to combat abuse (though there have been exceptions to that trend). We do not want to resurrect opportunities for artificial loss creation or open up new opportunities for it.

At present, if a business (incorporated or unincorporated) makes a loss and fails (as opposed to becoming profitable later) then the losses of the business and of its owners/investors can rarely be offset unless they have other income in the same year. A core motivation for the first two changes listed above is to allow entrepreneurs and investors to offset losses from a failed business venture against other income later on. The obvious danger with this is if business losses can be artificially manufactured on paper (without economic loss to the business/investor) purely to reduce tax liabilities elsewhere.

Another, related, concern with making the treatment of losses more generous is that it relies on only genuine commercial costs being deductible. We do not want to relieve ‘losses’ that arise from people deducting their personal consumption expenditure dressed up as business costs.

Note, however, that while both of these issues put more pressure on preventing and policing abuse, neither is really new to the system. Falsely claiming personal consumption as a business expense can already reduce positive profits to zero – is that risk to revenue any less bad than, or even different from, reducing them beyond zero (moving into loss) and offsetting positive profits elsewhere? And if I can

artificially generate losses, I can already use that to offset my income from other activities this year – is offsetting my other income next year a significantly different or worse danger?

Note also that the UK already has substantial anti-avoidance provisions which are framed quite generally to disallow arrangements designed purely to avoid tax rather than for genuine commercial purposes. Those existing anti-avoidance rules (or a simple extension thereof) might prevent some forms of abuse that might otherwise be possible.

We do not have the technical expertise to be sure whether the particular reforms to loss offset rules suggested here would increase the scope for abuse (to an extent that outweighed the benefits of the reforms). Before being introduced, they would need careful examination by people who do have that expertise, and it may be that only some of them are workable. But our investigations to date have not revealed any significant problems that these reforms would introduce. We are optimistic that some worthwhile steps could be taken in this direction if there were a concerted effort to make them work.

We must be vigilant to minimise abuse of loss offset provisions, but we must also pay due attention to the benefits of allowing genuine losses to be offset.<sup>97</sup> HMRC sometimes seems to regard almost anything that reduces revenue as regrettable. Yet revenue being reduced by the use of relief for genuine losses should be regarded as a success, not a failure. There are better ways to raise revenue than restricting legitimate loss offsets.

## **Package 9: increase CGT and dividend tax rates and reintroduce inflation indexation**

CGT and dividend tax rates could be increased, perhaps to match standard income tax rates, in return for reintroducing indexation of capital gains for inflation. This would move us back towards the system in place from 1988 to 1998. There would be no tax on purely inflationary gains, but each extra £1 of returns would be taxed at higher rates than at present, reducing the tax advantage to operating through a business and taking capital gains rather than income. The UK has experience of

<sup>97</sup> On the importance of loss offsets, see Goodman, Patel and Saunders-Scott (2020), for example; and for empirical evidence that loss offsets have an important effect on entrepreneurial risk-taking, see Cullen and Gordon (2007). Both of these papers relate to the US, which has a somewhat different tax system; we are not aware of similar evidence for the UK.

operating such an indexation allowance; it would add some complexity, but would not need to be as complicated as the way indexation worked in the past, and greater use of IT would make its operation easier in practice. Indexation need only apply for periods after the date of the reform (the date at which tax rates increased), with no indexation for earlier periods and no need for ‘rebasing’ asset values (which was one source of complexity in the past).<sup>98</sup>

Better still would be to index, not for inflation, but for an interest rate (the normal rate of return). In practical terms, this could operate in the same way and, as discussed in Section 3.3, it would be one way to implement an RRA (at least to the extent that capital losses relative to this indexed base could be offset – see package 8) so that only ‘excess’ returns would be taxed and investment not be discouraged. It also gives more scope than inflation indexation to minimise the complexities associated with indexation in the past.

With inflation and interest rates currently near zero, indexation is less important, and perhaps less worth the additional complexity, than in the past – though it would also be correspondingly less expensive. Even modest inflation / interest rates can have a surprisingly big effect on investment incentives, however. Indexation would become more important if inflation and interest rates rise, and there is a case for moving ahead of that.

## 5.3 Other combinations

Our focus in this report has been on those parts of the tax system that determine the taxation of investment and working in different legal forms. The packages discussed so far involve combinations of rate changes and base changes in that part of the tax system. However, in creating policy packages and addressing problems in the current system, it would also be possible to combine reforms in this area with reforms in other related areas of policy. Packages 10 and 11 are examples of this.

<sup>98</sup> Like us, the Office of Tax Simplification (2020) argues that ‘If Capital Gains Tax rates were more closely aligned with Income Tax rates, the OTS considers that the government should also consider reintroducing a form of relief for inflationary gains’. Addressing possible concerns about complexity, it adds: ‘The OTS does not dismiss these challenges but considers that integrated software and modern technology could go a long way towards addressing them’.

## Package 10: increase self-employed NICs in return for greater access to state benefits

As set out in Box 2.1, there are now only very small differences in the government-funded ‘contributory’ benefits that employees receive and the self-employed do not (and differences in employment rights, which are paid for by employers, cannot be offset through the tax system). The differences are:

- New-style (i.e. contribution-based) jobseeker’s allowance is payable for up to six months to employees with a sufficient record of NICs who lose their job, but is not available to the self-employed who lose work.
- The self-employed (who are paying NICs) are eligible for maternity allowance (MA) for 39 weeks, whereas eligible employees can claim statutory maternity pay (SMP), which also runs for 39 weeks but provides more generous benefits for the first 6 weeks.<sup>99</sup>

In principle, the government could pair higher tax rates for the self-employed with benefit entitlements that are also closer to those for employees. This may be difficult in practice. For example, producing direct equivalents for the two benefits would require, respectively: finding a way to assess whether a self-employed person has genuinely become unemployed and determining the average weekly earnings of the self-employed.

If the government chose to increase benefits and raise tax rates for the self-employed in a revenue-neutral way, it would be able to raise rates by less than 1 percentage point (reflecting the fact that the difference in benefits is so small). While all self-employed would face higher rates, most would not expect to benefit from the greater benefits.

<sup>99</sup> MA (if full eligibility criteria are met) provides £151.20 a week (or 90% of average weekly earnings if lower) for 39 weeks. SMP provides 90% of average weekly earnings (before tax) for the first 6 weeks followed by £151.20 (or 90% of average weekly earnings if lower) for the next 33 weeks. Many employed women get more generous maternity pay, which is provided by employers (i.e. not paid for by the government). The self-employed are also not entitled to statutory paternity, adoption or shared parental pay, which in aggregate expenditure terms are even smaller than SMP.

## Package 11: remove CGT uplift at death, in conjunction with reforms elsewhere

CGT uplift at death could be abolished, so that for CGT purposes those inheriting assets are deemed to acquire them at their original acquisition cost, rather than at market value at the date of death.

In December 2012, the government estimated that this relief would cost it £490 million in 2012–13, though it has declined to publish an estimate since then on the grounds that the cost cannot be reliably estimated from existing data.<sup>100</sup>

Uplift at death provides a huge incentive for people to hold on to assets that have risen in value, even if, in the absence of tax considerations, they would prefer to sell them and use the proceeds in some other way, and even if someone else could use the assets more productively. And the ability to escape tax in this way provides a big incentive to set up a business and roll as much money as possible into it, rather than working as an employee. These incentives would be exacerbated if tax rates on capital gains or income were increased. So abolishing uplift at death would reduce some distortions in its own right, and also remove one of the downsides of moving towards alignment of tax rates across legal forms. Ideally, removing uplift at death should therefore be prioritised as one of the first steps taken towards the long-run ideal we set out in Chapter 3.<sup>101</sup>

This could be done on its own; or it could be linked to other reforms to the treatment of people at or approaching death. The revenue from abolishing uplift at death (and perhaps removing inheritance tax reliefs such as for business assets, agricultural property and pension pots) could be used to pay for a reduction in the inheritance tax rate, evening out treatment between those who make money in different ways and/or bequeath different assets while maintaining overall incentives to work, save and pass on wealth. Alternatively, the revenue could be put towards a reformed system for funding social care, with the package presented as a fairer way for taxpayers' funds to support those approaching death and their descendants.

<sup>100</sup> The 2012 estimate is available in the National Archives at <http://webarchive.nationalarchives.gov.uk/20131113190813/https://www.gov.uk/government/publications/main-tax-expenditures-and-structural-reliefs>.

<sup>101</sup> The Office of Tax Simplification (2020) also recommends that the government consider removing uplift at death. It highlights the practical downside that this would increase the number of times difficulties arose because the original acquisition cost by the deceased could not be established (that problem can already arise now, but less often) and suggests some possible responses.

## 6. Conclusion: tax reform in the shadow of COVID-19

The problems and the big-picture solution that we have identified in this report are not new: researchers at IFS and elsewhere have been highlighting the problems for decades and the Mirrlees Review set out the big-picture solution almost 10 years ago. In reflecting on the lack of progress to date, we thought there were two key issues that were preventing reforms: a widespread belief that the preferential tax rates for business owner-managers are justified and a sense among at least some key players in tax policymaking that our proposed big-picture solution is too radical to implement.

One aim of this report has been to explain why the current tax system is unjustified and why the big-picture solution offers a worthwhile prize. At first glance, the full set of reforms we set out may seem like using a sledgehammer to crack a nut. But we are describing a set of reforms that would not merely solve one or two isolated issues but that would largely or wholly eliminate most of the problems that occur in our current taxation of work and investment; it is a large set of reforms to fix a large number of problems. The long-run ideal developed in the Mirrlees Review and described here would have benefits far beyond the small business sector, from the treatment of rental property to multinationals. In this report, we have focused on individual workers, investors and micro-businesses. But even there, the approach of combining tax rate alignment and tax base reform brings multiple benefits. Experience has shown that the arguably easier-looking approaches governments have reached for time and again have not worked – and they cannot work. Tweaking definitions of which groups are subject to which existing tax rates, or creating new intermediate statuses, merely shifts the problem to whatever new boundary or boundaries is/are chosen. Nudging tax rates on capital income up or down in isolation changes the balance between aligning tax rates on different legal forms and minimising disincentives for saving, investment and risk-taking, without

alleviating the tension between these objectives. Yet the problems can be solved. The combination of tax rate and base reforms we have outlined means that in this area, for once, we can have our cake and eat it.

Implementing all of the reforms in a short space of time would be radical, and possibly undesirable given the scale of the changes involved. But there is no need to choose between wholesale reform and virtual inaction. Another aim of this report has been to describe what we see as a workable middle ground: combining manageable but meaningful steps in the right direction – which can be carefully chosen from components of the big-picture solution – into packages in ways that mitigate the trade-offs inherent in partial tax reform. Packages could vary in size and while some might still be deemed radical in their own right, there are also smaller packages that would work as incremental steps in the right direction. While smaller steps cannot fully solve the problems with the existing system, some can help; in choosing sensible incremental reforms, it is important to have an ultimate end goal in sight, and we illustrate what small steps might look like and the trade-offs involved. There is no one ‘right’ path: each package entails different trade-offs. Our hope is that this report will act as a resource that others can use to create packages of their own.

Any reform will now happen in the shadow of COVID-19. Neither the problems nor the solutions we highlight have been fundamentally changed by the COVID-19 crisis. And we think that our proposed approach – to create packages that move the tax system towards the right ultimate destination – is still the right one. But COVID-19 could affect both the likelihood of reform and the pathway that is chosen if any reform happens.

In Spring 2020, when announcing the introduction of the Self-Employment Income Support Scheme (SEISS), Chancellor Sunak laid the groundwork for future rises in taxes on the self-employed, saying: ‘in devising this scheme – in response to many calls for support – it is now much harder to justify the inconsistent contributions between people of different employment statuses. If we all want to benefit equally from state support, we must all pay in equally in future’. The SEISS can be seen as evidence that not only are standard state benefits almost as generous to the self-employed as to employees, but the unspoken promise of emergency support the government provides to the self-employed is comparable to that for employees. Certainly that was the government’s stated intention; and, on average, the SEISS



has been roughly as generous to the self-employed as the Coronavirus Job Retention Scheme (the furlough scheme) has been to employees. But in practice some self-employed people have been overcompensated by the SEISS (resulting in a higher income than they had before the crisis) while others have fallen through the gaps: around 40% of those receiving any self-employment income before the crisis (18% of those receiving more than half of their income from self-employment) are ineligible for the SEISS.<sup>102</sup> And most company owner-managers have received little or no government support of this kind.<sup>103</sup> This will make it harder to raise taxes on these groups. Yet the fact that the government has struggled to target support for the self-employed accurately during this crisis is a weak argument for maintaining across-the-board low tax rates for business owner-managers.

It is always difficult to raise taxes on business owner-managers, as Philip Hammond found in 2017 when, as Chancellor, he tried to introduce a modest tax rise for the self-employed, only to back down in the face of fierce opposition. There are, however, three factors coming out of the crisis that should focus minds and make reforms in the direction we propose more likely.

The first is the likelihood of higher taxes in the long run. Even before the crisis, the public finances faced long-run spending pressures related to an ageing population. Now, the government will come out of the COVID-19 crisis with a higher structural budget deficit and demands for more spending on areas such as health, social care and welfare. Tax rises are rarely easy. But if taxes are increased, it seems reasonable that policymakers and voters will be looking to groups and activities that are currently taxed preferentially, which include those working through their own business. Higher tax rates also have the potential to exacerbate the problems caused by structural weaknesses in the tax base, and make it even more important to design

<sup>102</sup> In some ways, the SEISS was more generous than the CJRS, since the self-employed (unlike employees) did not have to stop working in order to qualify. As a result, it was possible to be made financially better off by the SEISS than if the crisis had not happened (see Adam, Miller and Waters (2020)); one in six claimants reported experiencing no loss in pay between March and September 2020 (Brewer et al., 2020). On the other hand, people who fell through the gaps in the SEISS included the newly self-employed, those for whom self-employment provided less than half their income and those earning more than £50,000 in the previous year. Note that there were also employees who fell through the gaps of the CJRS, notably – until November 2020 – those who cut their hours and earnings (for example, to care for children) but did not stop working completely. See Adam, Miller and Waters (2020) and Waters (2020).

<sup>103</sup> Company owner-managers who furloughed themselves qualified for the CJRS like other employees on the salary they received from the company. However, as discussed in this report, most owner-managers pay themselves predominantly in dividends, which were not covered by the CJRS or the SEISS, so they received little protection of that kind.

tax policy well. Better-designed taxes would allow us to raise more revenue with less economic harm.

The second factor is that there may be more focus on the quality of work (for example, on aspects such as job security, income predictability, personal autonomy and opportunities for progression). Self-employment is not necessarily ‘better’ or ‘worse’ than employment. Both have pros and cons, there is high- and low-quality employment and self-employment, and different statuses will suit people in different circumstances and with different preferences. But if we wish to avoid people being pushed into inappropriate and low-quality work, we should try to stop the tax system from driving individuals’ and firms’ choices. The 2017 Taylor Review, undertaken for the government, concluded that the current tax treatment of different forms of work ‘is not justified, or sustainable, nor is it conducive to the goal of a good work economy’. Recent evidence suggests that, even before the crisis, many of the self-employed were underemployed and were working through self-employment because they lacked better alternatives (Giupponi and Xu, 2020). It seems likely that more people will now want the security that can come with employment, but firms – many of which will be struggling during the recovery – continue to be incentivised by the tax system, minimum wages and employment rights to prefer using contractors over employees. Moves to align tax treatment across legal forms, and thereby treat similar people in similar ways, would be fairer and help to end the current practice of organising work structures around the tax system rather than around what people find best personally and commercially. The only way to stop the labour market being shaped by tax incentives is to fix the tax system.

The third factor is the challenge of rebounding from the crisis and returning to growth. As well as the general scope for raising revenues more efficiently, the tax reforms we lay out in this report offer ideas for how the government could choose a reform pathway that helped with the economic recovery and ‘building back better’. For example, we lay out reforms that would improve incentives for businesses to invest, employ people and take risks, and would do less to push people away from employment and into other forms of work that they may not prefer. Policymakers could choose a path that helps improve the structure of the tax system while also aiding the recovery and the rebuilding that are to come.

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