



# Many are called, few are chosen: The dilemma of taxing SMEs

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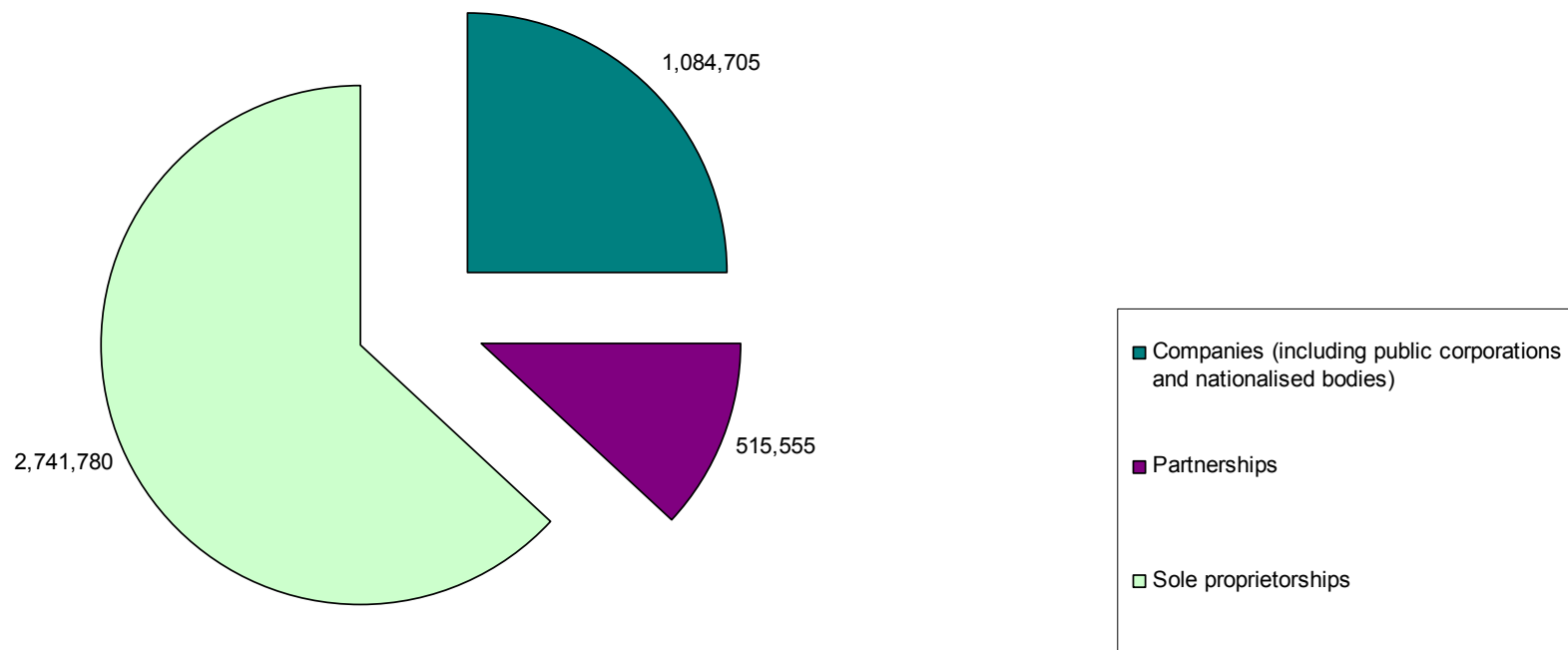
## Issues to be discussed

- The characteristics of SMEs
- Choice of corporate form
- Tax avoidance and evasion
- Special tax measures and incentives
- Conclusions

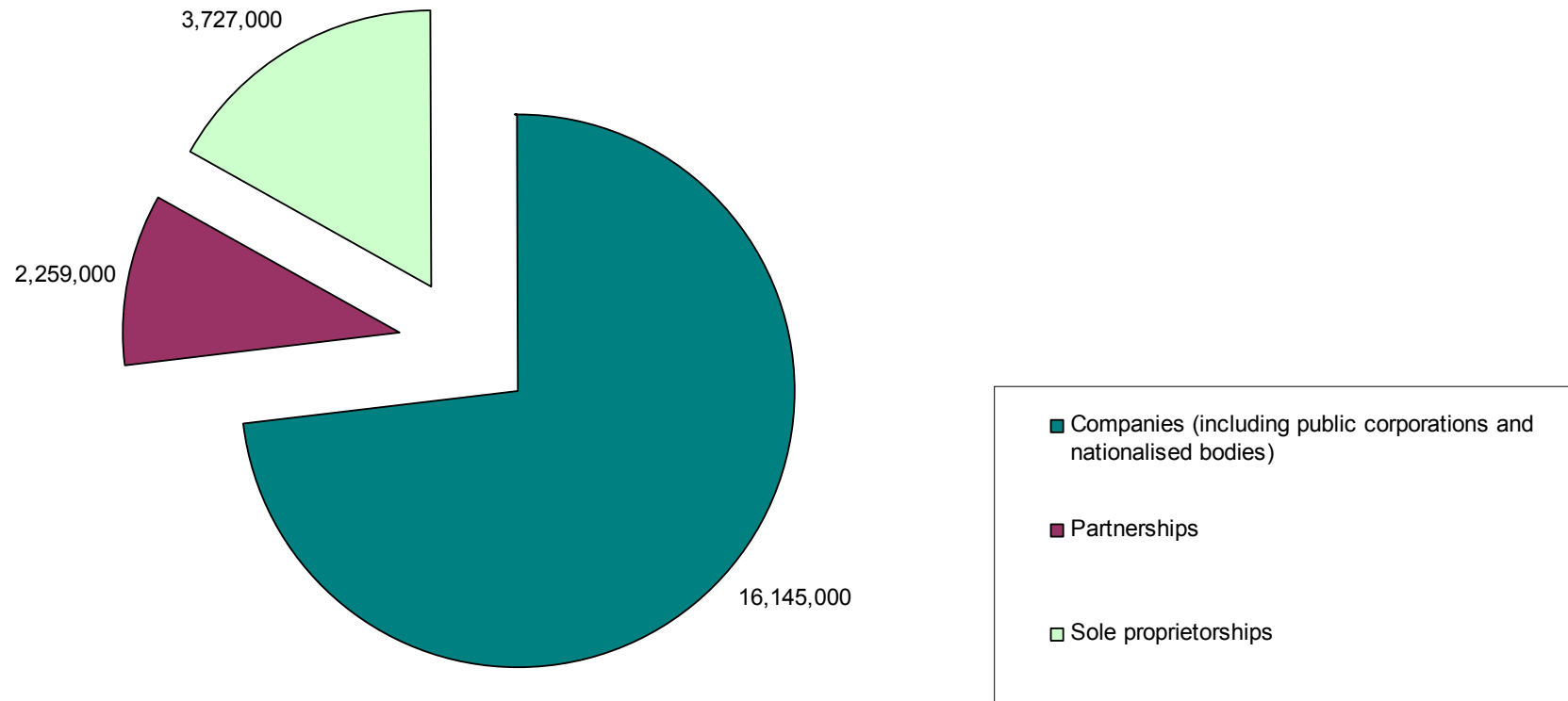
## Many are called

- Discussion of SMEs tend to start with talk about importance of these firms for entrepreneurship and employment (the motherhood and apple pie bit)
- ..... followed by statistics on all small businesses  
so .....

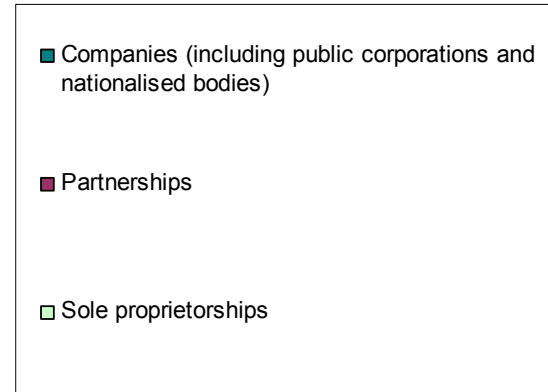
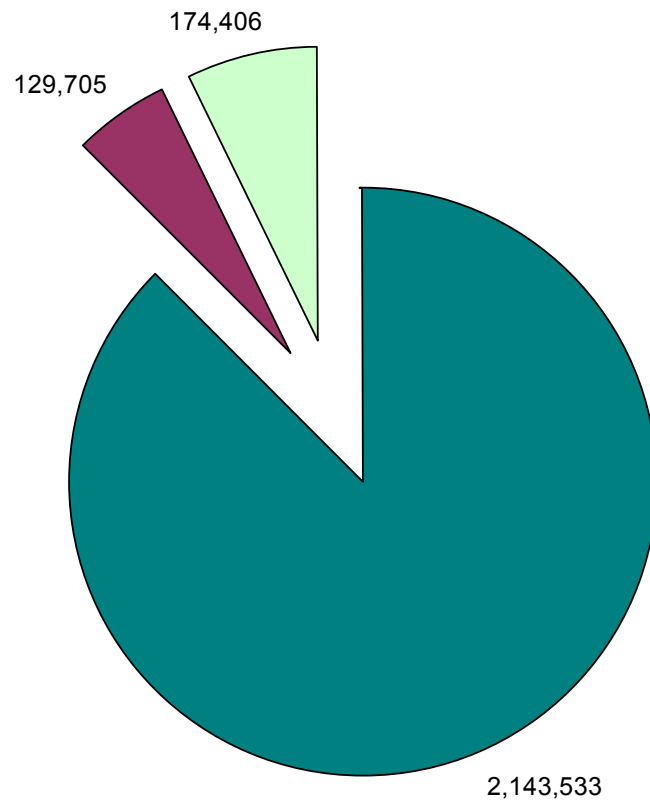
**Number of enterprises in the private sector (including public corporations and nationalised bodies) by number of employees and legal status, UK, start 2005**



**Employment in the private sector (including public corporations and nationalised bodies) by number of employees and legal status, UK, start 2005 (/1000)**



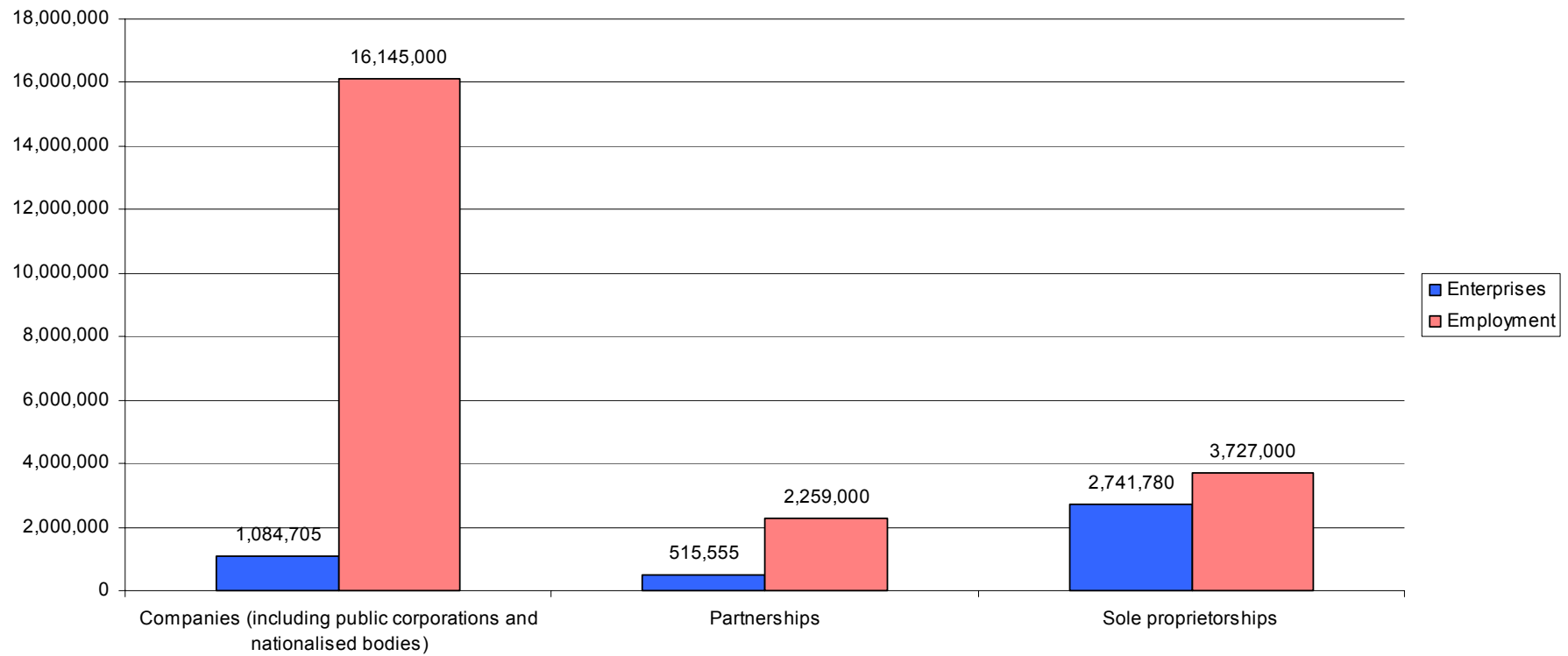
**Turnover in the private sector (including public corporations and nationalised bodies) by number of employees and legal status, UK, start 2005 (£'s million)**



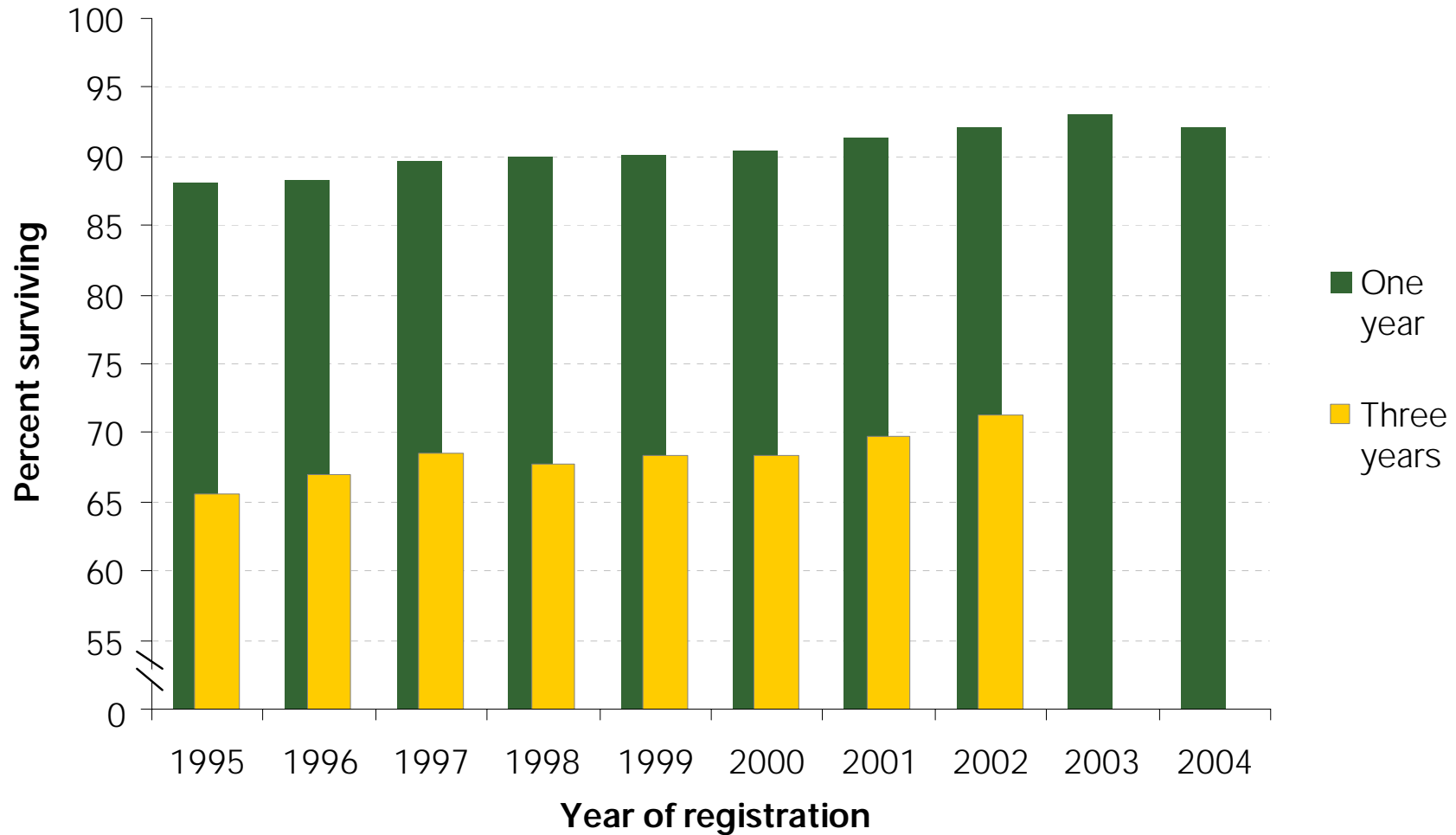
## Statistics on "small" businesses in the UK in 2005, by legal form

	All	Number (%) with fewer than 10 employees	Number (%) with no employees
Incorporated (companies)	1,084,705	934,240 (86)	418,950 (39)
Unincorporated	3,257,335	3,214,290 (99)	2,743,650 (84)
Partnerships (including LLPs)	515,555	487,110 (94)	323,345 (63)
Sole Proprietorships	2,741,780	2,727,180 (99)	2,420,305 (88)
Total	4,342,040	4,148,530 (96)	3,162,600 (73)

### Number of enterprises and employment in the private sector by number of employees and legal status , UK, 2005



## Percentage of enterprises surviving one year and three years after registration, UK, 1995-2004



## But few are chosen

- The number of SMES that are important for economic growth and job creation is of much smaller magnitude.
- Typically
  - Most small firms do not grow
  - Less than 4% of SMEs create around 50% of the jobs in small firms
  - Most do not survive a decade and create few additional jobs over and above those with which they started
  - Technologically advanced or innovative SMEs are very rare beasts
  - And therefore hard (impossible?) to find and target the economically important SMEs ex ante

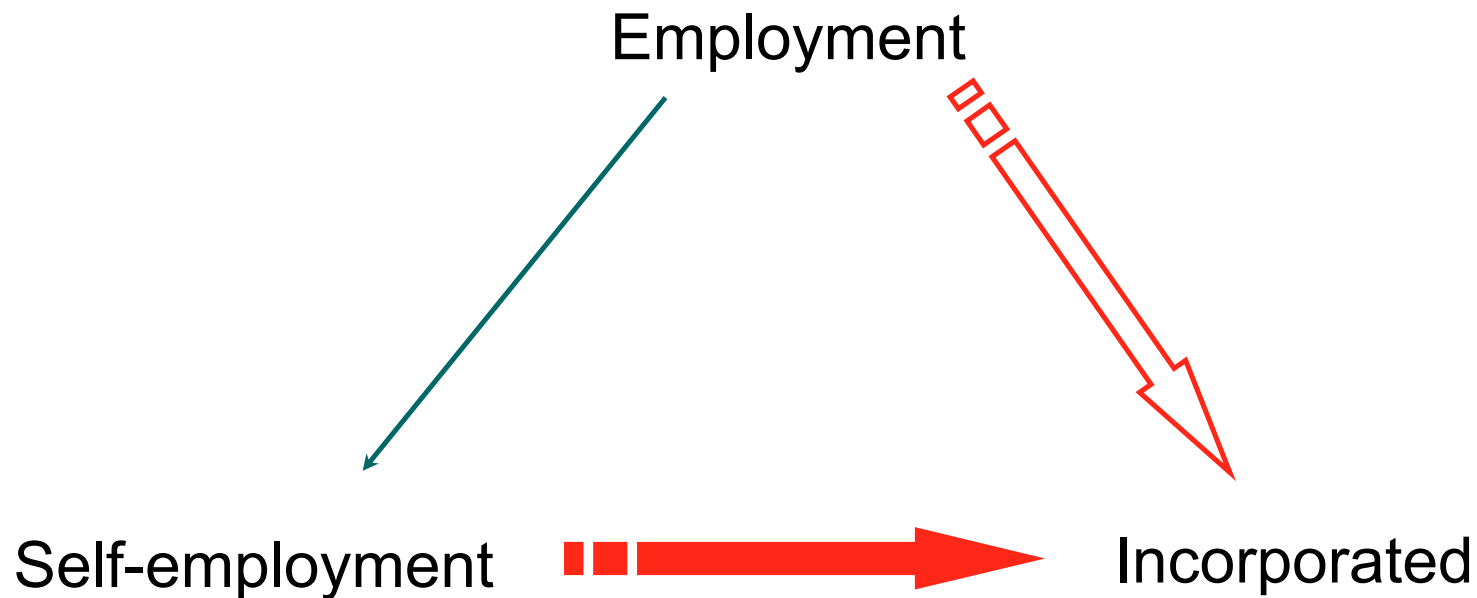
# Policy Rationales for supporting SMEs

- Market failure – adverse selection, information costs, etc. Hard to distinguish genuine market failure from the market working and weeding out bad deals.
- Capital or equity gaps are difficult to define and measure because we cannot get at the counterfactual of what the “state of the world” would otherwise have emerged. EC state aid risk capital (SARC) guidelines put the upper bound of the equity gap at €1.5million. The UK’s Enterprise Capital Funds and tax-advantaged venture capital schemes (Enterprise Investment Scheme, Venture Capital Trusts, and Corporate Venturing Scheme) have a £2 million fundraising limit per year.
- Structural features – Admin burdens (e.g. first employee), complexity (e.g. incurring professional fees), and “cliff edges” of targeted SME tax incentives. A mixture of the unavoidable and the inevitable if you want to target assistance at SMEs. Aim should be for burdens and complexity to be minimised and proportionate.

# The Choice of Legal Form

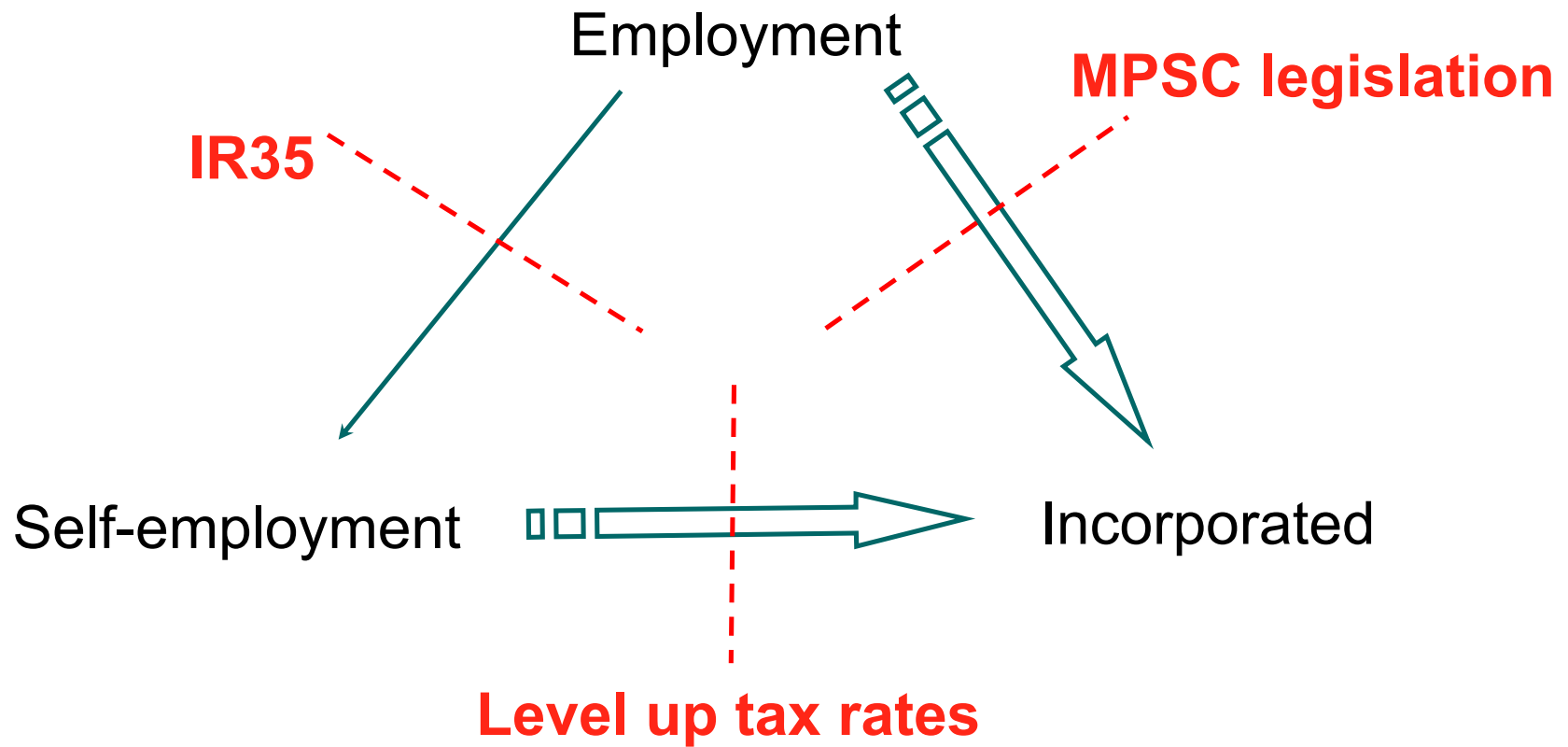
1. Employment - wages  
[IT, NICs (class I)]
2. Self-employment - wages  $\approx$  profits  
[IT<sub>SE</sub>, NICs<sub>se</sub> (class II and IV)]
3. Incorporated - wages, dividends  
[IT, NICs (class I), CT]

# Stylised Flow to Incorporation

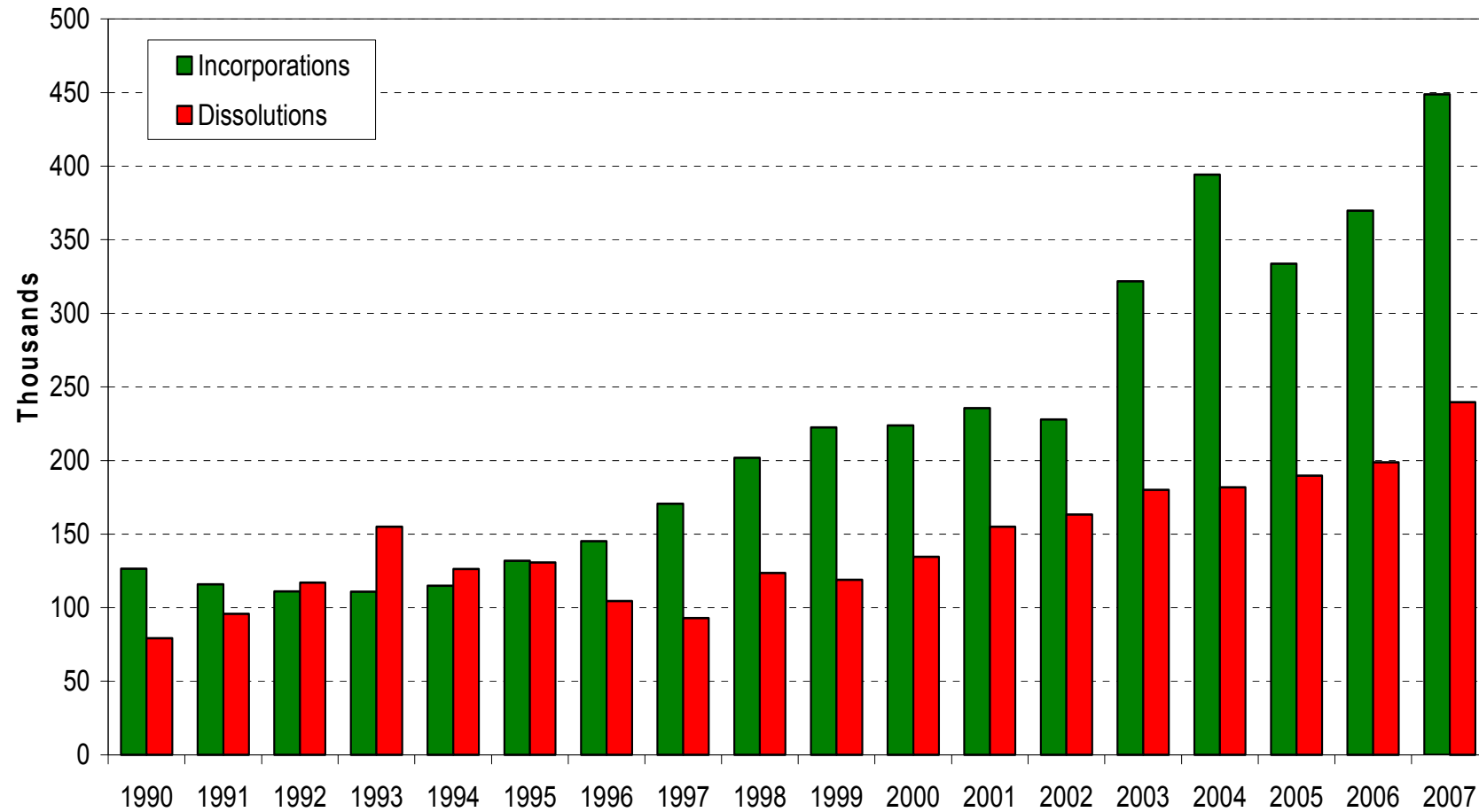


**Tax-motivated incorporation (TMI)**

# Policy Responses



## Annual Incorporations and Dissolutions - Tax Year Ending



Source: Companies House

# Distortions to Employment vs. Self-Employment

- Lower National Insurance (lower rates) and more allowable expenses (narrower tax base) mean the UK tax system can encourage employees to become self-employed.
- Lower National Insurance only partly reflects less generous entitlements to state benefits for the self-employed. This is because the UK tax system implicitly makes allowance for the fact that self-employed income is the product of both capital and labour and the rates of tax on capital are lower than for labour.
- In theory, the existence of preferential tax treatment for some savings and investment vehicles should only have a negative marginal effect on SME creation. However, this will depend on the relative post-tax rates of return, the capital intensity of the business start-up and who owns the capital.

# Tax Distortions to Unincorporated vs. Incorporated Business

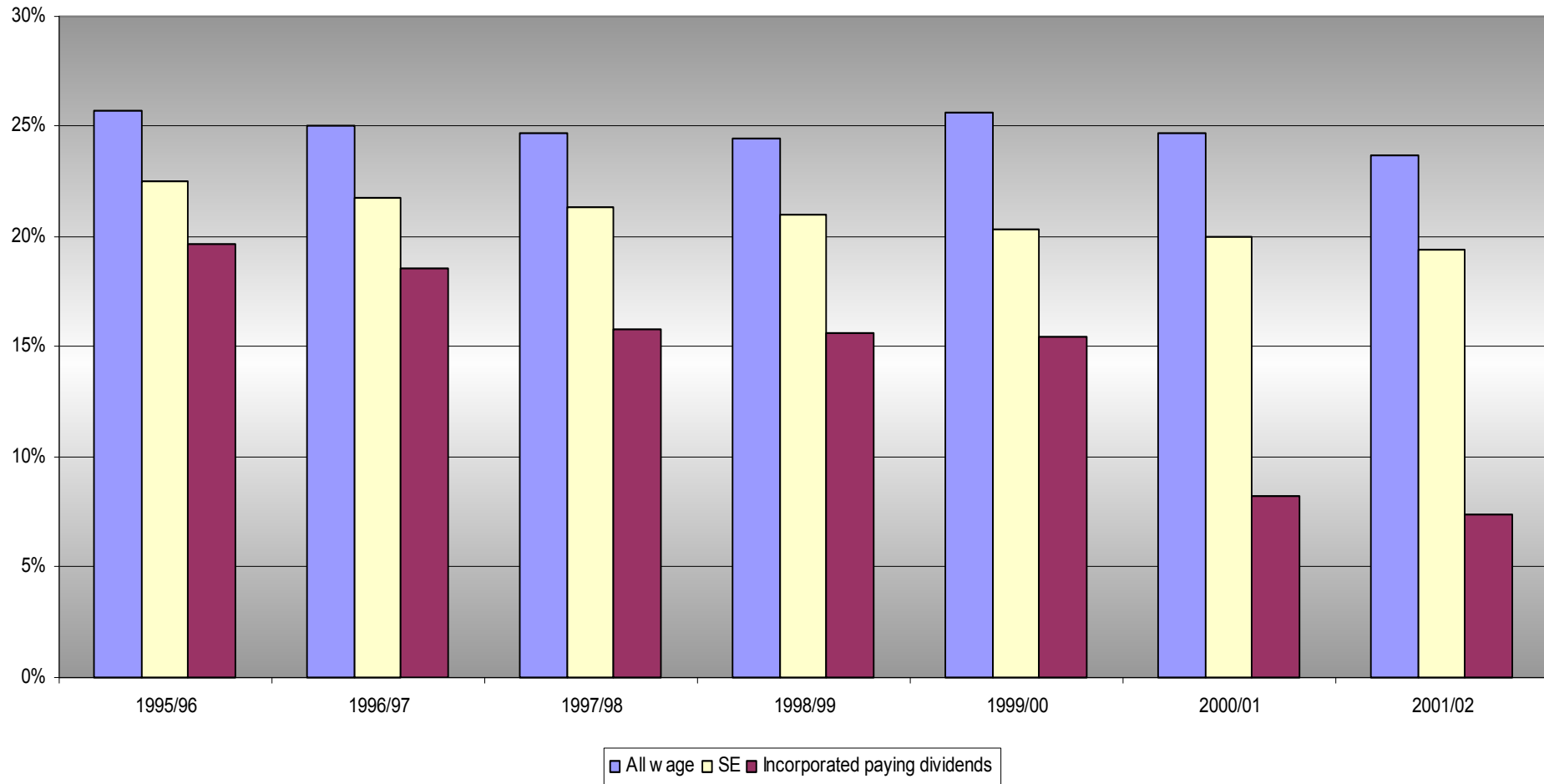
- If the combined corporate and dividend tax rates payable by the incorporated are lower than the combined income tax and National Insurance payable by the self-employed, then so-called tax-motivated incorporation will occur.
- Incorporation in the UK is very cheap (£20), it is available on-line, and there are no capital adequacy requirements to restrict the use of companies. It is so cheap and straightforward to incorporate here that we have seen sizeable numbers of foreign businesses registering as UK limited companies.
- Successive Governments have tried to encourage greater investment through low rates of tax for small companies. However, this can be taken advantage of by people incorporating with the aim of reducing their tax and National Insurance liability by extracting labour income as dividends.

# Tax Avoidance or Legitimate Business Choice

- In the UK, tax-motivated incorporation became particularly apparent following the introduction of a 0% corporation tax band for the first £10,000 of profit in 2002-03. This was withdrawn after 3 years (2005-06).
- The latest Budget went further. The Chancellor of the Exchequer announced a phased increase in the small companies rate of corporation tax to 20% in 2007-08, to 21% in 2008-09, and 22% in 2009-10,

# Average Tax Rate by Legal Form (1)

Average Tax Rates for an individual earning £15,000 depending on their status



# SME Tax Evasion

- Considerations contributing to SME tax evasion are the ability to under report income (e.g. cash-in-hand) and over report business expenses (e.g. personal consumption of business assets).
- Measures to reduce tax evasion – targeted and random enquiry programmes (both direct yield and deterrence effects), providing information in a customer focussed way to reduce error, (different channels, website, help lines, etc), and tax evasion hotlines. Trade-offs: enquiries impose a high compliance burden so need to be targeted and proportionate to risk.

## Awareness of Special Tax Incentives Amongst Small Firms: Recent Survey Evidence

- Survey carried out in July 2006 by PWC
- Awareness levels for incentives and reliefs limited. Average across nine named schemes of 41%
- Usage levels are low - average across schemes looked at was 11%
- If first year allowances on capital assets is excluded usage drops to 7%

## Awareness of Special Tax Incentives Amongst Small Firms: Recent Survey Evidence

- Highest awareness (64%) was for first year allowances and R&D tax credits (57%)
- Lowest was 14% for corporate venturing
- A third of companies for whom R&D tax credits were relevant did not claim them as the process was perceived to be too difficult.
- Incentives don't appear to influence business decisions in most cases even where used, e.g. only 24 influenced by capital allowances.

# Survey Results: Comparison of nine incentives and reliefs available to SMEs

Incentive	Awareness (%)	Overall usage (%)	Aware but not used- believed irrelevant	Used and influenced business decisions (%)
FYAs for capital assets	64	48	19	24
Tax deductions for employee share schemes	59	11	65	39
R&D tax credits	57	9	59	21
EIS and VCT	52	6	74	50
Capital Allowances on green technologies, flats over shops and contaminated land	45	10	55	23
Taper relief on sale of shares	45	8	69	40
Enterprise Management incentives scheme (share options)	18	3	73	----
Ability to sell subsidiaries tax free (SSE)	18	5	66	32
Corporate venturing scheme	14	1	76	-----

# Why don't SMEs use reliefs available?

- Mainly because not relevant but:
- Perception that they are difficult to claim with detailed and complex criteria (which generally exist to deal with avoidance issues)
- Uncertainty as to whether claim would succeed
- Lots of SMEs unaware of their existence so questions over communication strategy used by government

# Experience of Targeted Tax Relief for SMEs

- Incentives are often trying to target qualitative factors such as being “growth orientated” and so high deadweight use of the schemes is likely even with targeting rules. Targeting also creates “cliff edges” and can require anti-fragmentation rules. Allowing businesses that are “too large” into a scheme can mute the competitive gain the most needy users can derive from it (because barriers to entry are hardly lowered), while pushing up deadweight, etc.
- UK uses tax measures targeted both at businesses (enhance capital allowances & SME R&DTC) and investors to aid SME financing (venture capital schemes). There are none specifically targeted at institutional investors, although these and experienced individual investors tend to advise the business to exploit these incentives to aid growth and reduce the tax wedge on their expected rate of return.

# Targeted Tax relief continued.

- Reducing compliance burden on self-employed – Trade-off between gathering enough information to assess risk and the compliance costs imposed on the business. One difficulty with most exemption schemes (like VAT exemption or possible simplifications that could be made to calculate expenses in a formulaic way) is that their existence can raise compliance costs for business as they recalculate each year whether it is worth being “in” or “out”. So take-up can end up being driven by whether the business can lower its tax bill, rather than simply reduce compliance costs.

# Conclusions

- Lower CT rate for SMEs tend to be politically motivated
- Arguably no real economic rational for lower small companies rate
- Can cause distortions in terms of choice between employment, self employment and incorporation
- Need for associated companies rules to stop companies splitting into smaller entities to pay lower rate. Means even more tax complexity!
- But ... are tax incentives for SMEs better than subsidy programs despite deadweight costs which might otherwise take their place?