



# Proposal 4

## Promoting growing and enterprising businesses

The reform agenda set out in this report is based on the premise that corporate tax reform should be broad based and benefit all taxpayers. The goal is to improve the international competitiveness of the UK corporate tax system. Much of the focus is therefore on large MNEs which are, by definition, international. However, it is important to recognise that in terms of importance to the UK economy SMEs<sup>124</sup> are at least as significant. For example, in 2006 SMEs accounted for 58.9% of all employment and 52% of all private sector turnover.<sup>125</sup> It is critically important therefore that any reform aimed at improving the competitiveness of UK business recognises the needs of the SME sector.

### Key tax issues facing SMEs

Not only are SMEs important to the UK economy, they have particular tax issues that are not faced to the same extent by larger businesses:

- Administrative burdens fall disproportionately on SMEs. It is estimated that 70% of the burden of tax regulation falls on firms with fewer than ten employees.<sup>126</sup> This means that SMEs are particularly concerned about tax complexity and onerous compliance obligations. This is costly both in terms of advisers' fees and management time, and represents a hidden cost which pushes up the effective tax rate. This administrative burden extends across all forms of regulation and detracts from economically productive activity. This "dead-weight loss" can be potentially a greater problem than the financial cost of taxation.
- Tax is a significant obstacle to growth for SMEs. The Annual Business Survey 2005 undertaken by the then Department for Trade and Industry (now Department for Business, Enterprise and Regulatory Reform) showed that 38% of SMEs that wanted to grow their business cited tax as a barrier to growth.<sup>127</sup> This is a particular obstacle for SMEs with limited access to debt finance.

- Losses weigh more heavily on SMEs than on larger and more established businesses. Tax is paid immediately on profits, but relief for losses is not given until the business generates sufficient taxable profits to absorb past accumulated losses. Losses generally include tax allowances aimed at stimulating investment in the SME sector. These are of limited value when they cannot be monetised at the point at which the business really needs them.
- There may be a strong policy reason for encouraging investment in SMEs as they have a fundamentally different risk profile to larger, more established businesses.

For these reasons, there may be valid arguments for specifically addressing some of these issues through the corporate tax system. Although such differential treatment adds a little to the complexity of the system, it can be justified on the grounds that the tax system should enable SMEs to compete on a level playing-field with larger established businesses.

It is recognised, however, that for the smallest businesses it is difficult to consider corporate tax in isolation. There are important questions about how the tax system deals with the employed/self-employed boundary and the unincorporated/incorporated boundary. Addressing these issues goes to the heart of the entire structure of the UK tax system.

A key issue is how growing and enterprising businesses can be incentivised without encouraging tax-motivated incorporation. Government policy in this area has lacked strategic direction and in addition to corporate tax reform, radical reform may be required to the income tax and national insurance system. These other taxes are not the focus of this report. One point should be stressed however. Recent increases in the small companies' rate of corporation tax in an attempt to address the problem of tax-motivated incorporation do not get to the heart of the issue. This is a blunt tool that unfairly punishes all business paying the small companies' rate and should be reversed.

In addition, taxes that are not directly paid by business are critically important to encouraging investment and enterprise amongst SMEs. For example, the importance of a competitive regime for taxing gains realised on the disposal of business assets has had much recent attention and rightly so.

### **SMEs should benefit disproportionately from simplification**

The reforms recommended in this report are aimed at improving the competitiveness of all UK businesses. Because SMEs are disproportionately burdened by the complexities of current corporate tax system, they should also, without any special measures, benefit disproportionately from simplification.

Further alignment of taxable profits with statutory accounts should simplify the tax position of many SMEs. With the exception of allowances for investment and R&D, and perhaps a general anti-avoidance provision on personal expenditure, adjustments from the statutory accounts should be kept to an absolute minimum.

The deduction of all genuine business expenses from the tax base, and the reform of the capital/revenue divide would also be important simplifying measures. Because this means that incidental costs of raising equity would be deductible, SMEs that rely relatively heavily on equity finance should be particularly advantaged.

It is accepted that a degree of complexity will still be required to tax complex multinational businesses but SMEs could be exempted from many of these rules without a significant loss of revenue or opening up opportunities for avoidance. For example, small companies are exempt from transfer pricing regulations, but it is not always clear that this applies to medium-sized companies. There are circumstances in which medium-sized businesses can be caught and some complain that, in effect, they must do all the administration work to calculate whether or not

the exemption applies. It should be made clear that medium-sized businesses are always exempt from transfer pricing regulations.

Additional proposals that would reduce complexity for SMEs include:

- Improvements to the associated company rules as they affect the small companies' rate
- An annual round sum expense allowance of £250 per company or business for tax-deductible items for which invoices or other documentation would not need to be held
- A review of all thresholds for tax
- That online filing of tax returns and online payment of tax be optional for SMEs

This practice of simplification for SMEs should be extended wherever possible and would result in reduced administrative costs both for SMEs and for HMRC.

### **SME tax rate**

Recent increases in the small companies' rate should be reversed. The rate should be reduced to 18% in a phased manner within three years to provide a boost to enterprise. The 18% tax rate has a cost of some £2bn per year if compared with the 22% now included in the Treasury's fiscal baseline (see costings on page 52).

This report is recommending that the main rate of corporation tax is also reduced to 18% over an eight-year period. Once achieved, this would deliver a main rate of corporation tax at the same level as the small companies' rate. This opens up an important debate about whether, once the main rate of corporation tax reaches 18%, the small companies' rate should be merged with the main rate, or whether it should be retained at a lower level still. It is considered that merging the two rates to one

single rate of corporation tax would be an important simplification. It would remove complications, such as the associated company rules, marginal tax rates, concerns about uprating of profit thresholds, and remove distortions around the boundary between small and large companies. However, this simplification will deliver benefits only if it is implemented when the main rate is reduced to 18%. This reform is not designed to raise the overall tax burden. Therefore, to merge the small companies' rate and main rate above 18% would outweigh the benefits associated with simplification.

### Simpler administration

There is also significant scope to improve tax administration for SMEs in particular. The principles set out in the Varney Review of HMRC's links with large businesses should, where scalable, be extended to the administration of SMEs. This would involve:

- A risk-based approach to SME tax administration. A track record of good compliance should be rewarded with a lighter touch from HMRC.
- A simplified and streamlined tax compliance process, including a one-stop shop for all HMRC-administered taxes.
- A single, direct and local point of contact within HMRC for all SMEs, rather than a call-centre approach. This is particularly important to SMEs that often cannot afford professional advice.
- Consistency of approach from HMRC across all businesses which meets published service standards for dealing with formal enquiries and answering queries from taxpayers.

### Incentivising enterprise

The task force has considered whether there is merit

in more radical reform of the taxation of SMEs. Radical reform is warranted if it does not over-complicate the corporate tax affairs of the 93% of corporate taxpayers who together account for just 13% of total corporate tax revenues,<sup>128</sup> while at the same time incentivising investment in the small business sector. This report suggests that two specific measures are appropriate.

#### 1. *Enhanced allowances for investment*

Removing the tax barriers to growth and encouraging investment are two of the key issues relating to the taxation of growing, enterprising businesses. Therefore it is recommended that the new annual investment allowance be retained for SMEs but at an enhanced level, despite the more general move to accounts-based depreciation. This should not be subject to the same restrictions as the current associated company rules and should be claimable for each individual company. It is estimated that the initial Exchequer cost of raising the allowance from the current £50,000 limit to £100,000 would be in the region of £400m per year. In the longer-term the net cost would ease or even turn negative, partly because unrelieved capital expenditure would reduce over time, and partly because of the extra tax revenues associated with improved business survival and expansion (see costings on page 52).

An enhanced annual investment allowance would achieve the objectives of encouraging investment in growing, enterprising businesses and improving cash flow for small companies without being unduly complex. It is relatively simple in comparison to a complex system of capital allowances and is just an extension of the £50,000 annual investment allowance. In addition, investment allowances specifically target growing businesses which invest for the future. This is unlikely to stimulate tax-motivated incorporation and is therefore significantly more attractive than a zero corporation tax rate for small firms.

It is recognised that transitional provisions will be required when companies previously entitled to investment allowances become sufficiently large that

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they no longer qualify. It will also be necessary to identify assets for which relief has already been given and disallow the relevant depreciation. This will generate some additional complexity but the system overall is considered to be reasonably simple.

The task force did consider a system for the differential taxation of retained and distributed profits as an alternative method of encouraging investment in SMEs, however, this may be contrary to the EU Parent-Subsidiary Directive and is potentially complex. Therefore investment allowances have been recommended to encourage investment whilst being relatively simple and in accordance with EU laws.

## 2. Reducing the burden of investment losses

The treatment of losses is the other key issue for small companies. Tax is paid immediately on taxable profits, but relief for tax losses has to wait until the business generates sufficient taxable profits to absorb past accumulated losses.

To alleviate some of the burden of tax losses on SMEs it is recommended that a system of payable credits be introduced for SMEs that are otherwise unable to benefit from enhanced investment allowances as they are not yet sufficiently profitable. These should be equal to the tax value of the annual investment allowance, plus any additional allowance or relief due for capital depreciation. This would incentivise SMEs investing in their future. It is recognised that such a system would need clearance under EU State Aid rules.

The cost of doubling the annual investment allowance is on its own comparatively modest<sup>129</sup> but the cost of making payable the tax losses relating to this and other investment relief is more significant.<sup>130</sup> The initial cost to government is estimated to be in the region of £2.4bn in the first year, easing over time to £1.2bn by year eight based on a £100,000 annual investment allowance (see costings on page 52). If the annual allowance were kept at the current £50,000, the initial annual cost of upfront payments would be only a little lower at £1.7bn.

## Reforming other taxes that add to the business cost base

The recommendations in this report would significantly benefit growing enterprising businesses. However, it may be that resources could be more efficiently targeted by relieving the burden of taxes that add to the SME cost-base (employer NICs, business rates, etc). Reforms to taxes that impact the cost-base are attractive because companies benefit regardless of whether they are making a loss or a profit. In addition, other taxes do not discriminate between incorporated and unincorporated businesses and therefore targeted reform of these taxes can be used to incentivise all businesses without encouraging tax-motivated incorporation.

It is vitally important that the corporate tax system does not unfairly burden growing and enterprising businesses. Simplification of the entire corporate tax system will do much to relieve this burden. However, given the importance of SMEs to the UK economy, there are merits in continuing to recognise their specific challenges within the corporate tax system. An annual investment allowance of £100,000 for SMEs, available in full even when a business is not generating sufficient taxable profit, is considered to be an effective way of achieving this. However, reform of non-corporate taxes may be more advantageous for SMEs, particularly once the wider recommendations in this report have been implemented.

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