

# Blue sky thinking

In the week of the final spring Budget **KEVIN SLEVIN** thinks it is time for a radical overhaul of the business taxation regime.

**A**s I listened to the BBC's *Today* programme recently, a presenter informed me that Matthew Taylor, the head of Theresa May's independent review of modern employment practices ([tinyurl.com/htx8y4s](http://tinyurl.com/htx8y4s)), had announced that businesses were using self-employment rules to avoid tax. My immediate reaction was 'Well spotted, Mr Taylor', but I then began to speculate as to the new 'tinkering' measures that would be announced once his review was complete.

It is wrong to prejudge the likely impact of Mr Taylor's efforts, but what he does not know (and neither do you, dear reader) is that I have long been pondering a radical new approach to the UK's tax system for business activities. At one point, I toyed with the idea of producing a detailed paper – one that would explore the key issues and what I call the spin-off ones. However, it seems better to sketch out my ideas in the hope of stimulating debate to see whether they can gain some traction. Having been spurred on by the reports of the review, this article might include some ideas that merit further consideration.

I propose to exploit my Irish heritage in full by suggesting to Mr Taylor that, if I were looking for a solution to the issues he is exploring, I would not start from here. It would make far more sense to start from somewhere else – returning to the taxation of workers later.

So, let's start this 'pathfinder article' by exploring another topic altogether – a preliminary offering to stimulate thought. My first proposal is straightforward, but has far-reaching ramifications: the total reform of business taxation by exploring one simple idea. Of course, it has been said that all simple ideas have one thing in common: they tend not to work. But please

## KEY POINTS

- Matthew Taylor will be reviewing modern employment practices.
- Could this review be the basis of a wider review of business taxation?
- A profits tax that operated for all business types might eliminate discrepancies.
- Should National Insurance be levied on dividends payable to director-shareholders?
- There is scope for the further simplification of capital allowances and expenses.



bear with me: what follows is written from the standpoint of common sense and could be implemented. There would be winners and losers – to be honest, more losers than winners – but it would be much fairer.

## A new business profits tax...

Why should not all businesses (other than, say, publicly quoted companies, companies or groups turning over more than £25m and perhaps those below a £50,000 *de minimis*) be taken out of the scope of both corporation tax and income tax and instead be charged to a new business profits tax (BPT).

A business would be liable to BPT whether carried on by a sole trader, partnership, unquoted company or the trustees of a settlement, and the rate would be, say, 20%. Simply take the bulk of the existing corporation tax provisions and apply them to all businesses. So, an enterprise making a profit of £100,000 would attract the same liability regardless of the business vehicle.

Likewise, a large professional firm spending £20,000 on, say, business advertising would enjoy the same level of relief after tax as would a company incurring the same cost. Capital allowances available would attract the same rate of relief too, regardless of how the business was structured. Those reliefs currently claimable only by companies would be available to all businesses and the pound for pound benefit would be the same whether the chosen business entity was a limited company, a limited liability partnership, an ordinary partnership or, indeed, when the business was simply operated by a sole trader.

Both the lower and upper turnover thresholds would need a taxpayer-friendly transition provision. This might involve, say, two years' notice of a pending change if a business is expanding or contracting.

## ... and a business distributions tax

All 'drawings' from any business liable to BPT would be subject to a new business distributions tax (BDT), which would be similar or indeed identical to the pre-April 2016 treatment of company

distributions. Thus, business profits would no longer fall within income tax. Instead, they would be charged to BPT and would be exposed to BDT only to the extent that profits were withdrawn from the business. A measure equivalent to the 'loans to participator rules' could operate to prevent avoidance, but these and other peripheral matters can be explored another day.

In short, while dividends from a company would continue to be included in a taxpayer's total taxable income calculation, as they are at present, drawings from an unincorporated business would be treated identically. The individual concerned would include these drawings in his total income which would be taxed in the same way as pre-6 April 2016 dividends received from a UK company. However, not only would credit be given for the underlying BPT, but it could be repayable if the business activities generated only a low income.

## Individual specific reliefs

Instead of the personal allowance being deductible in arriving at taxable income, everyone involved in a business would be entitled to a tax credit, arrived at having due regard to their other income. Possibly, the personal allowance could be of equal value to all taxpayers. Indeed, perhaps all personal allowances should be expressed as non-refundable tax credits. These could be taken into account in the individual's total taxable income calculation to reduce liabilities accordingly. These would be a separate from the credits attaching to distributions from a company or an unincorporated business, which would be refundable where appropriate as described above.

In summary to this point, just as shareholders in companies do not pay tax on profits accumulated by the company (rather than being paid out as dividends), this treatment would also be afforded to unincorporated businesses.

Although this may give rise to the possibility of abuse, it is not anticipated that the detailed provisions will give rise to a tax loss greater than the extra revenue created by the further measures addressed below (although the Treasury will have to do the sums here).

Counter-avoidance provisions could operate to prevent cash accumulations within any business, whether incorporated or not. These could be bolstered by the inclusion of a subsection containing a statement as to parliament's intentions, as well as confirmation that the legislation is not intended to encourage non-commercial justifiable retention of funds.

## National Insurance contributions

To eliminate the current advantages of some business structures, it will be necessary to address the crunch issue of National Insurance contributions (NICs) by asking: should sums liable to BDT be liable to these as well?

According to data released by the Office for Budget Responsibility (OBR) for 2016-17, NICs are estimated to raise £124.4bn, 17.5% of the government's total income receipts for 2016-17. The OBR suggests this is equivalent to an NIC liability of £4,500 on each UK household. It is not clear, however, whether the OBR's conclusion took account that the occupants of many households reduce their NIC liabilities significantly by extracting business income as dividends.

At present, NICs are levied only on what the OBR refers to as 'labour income' – the wages and salaries of employees and the earnings of self-employed individuals below the state pension age. Further, employers make substantial contributions as well. The current employer NIC levy is 13.8% of earnings above the secondary threshold (£156 a week at the time of writing).

Is it not reasonable to assume that the only people likely to believe that it makes sense to continue to allow those involved in running a profitable business to have the choice of opting out of paying NICs are those involved in running a profitable business?

## Time for a change?

Viewed from the standpoint of a voter (or a citizen who happens to know a little about the UK taxation of business profits), it is not difficult to conclude that the same level of employee and employer NICs should apply to all that income, whether derived as remuneration, dividends, or as drawings from an unincorporated business. Of course, those operating through a corporate structure might have to differentiate between worker-shareholders and non-worker shareholders although, arguably, only few companies would have to do this. But there is a solution. In this increasingly digital age, each company could be required to register its shareholders with HMRC and, in doing so, to identify all non-worker shareholders. Indeed, taking things a stage further, matters could be organised to pre-populate each shareholder's tax return with their income from all unquoted UK companies.

## “It will be necessary to address the crunch issue of National Insurance contributions.”

However, stepping back for a moment from the suggested NIC distinction between worker-shareholders and non-worker-shareholders, it is reasonable to ask why an employee and their employer should have to pay a small fortune by way of NICs on a salary of, say, £150,000 while an individual receiving a dividend of the same amount pays none. If we are striving for a more equitable and, dare I say, logical system, should not NICs apply to *all* income of those of non-pensionable age (other than pension income), regardless of its nature? Would this not be a more equitable approach than that now operating?

This would have the advantage of reducing the administrative burden of deciding whether NIC should be deducted from a dividend payment, although the company would still need to be able to identify worker-shareholders to account for the 13.8% employers' contributions payable on dividend payments to employee-shareholders.

## A rate reduction

Following the above suggestion, it could be – again the Treasury would have to crunch the numbers – that the adoption of the new system would allow the NIC rate to be reduced.

It may be politically undesirable to regard NICs as just another tax and I may be criticised for overlooking the principle that it is a worker's obligation to make NICs, but the reality is that these play an increasing role in funding the National Health Service (NHS) and it is accepted that they are no longer solely intended to fund social security benefits or the state pension. Papers released to the House of Commons library in December 2015 indicated that, of the estimated total NICs paid to the government for the year 2014-15, some 20% was diverted to the NHS, albeit in accordance with the regulations.

Further, those tempted to deride any suggestion that all dividends should attract NICs will have a hard time showing that parliament decided that the policy should be to allow, for example, director-shareholders to opt out of paying these by following the dividend payment route. Some will say that parliament's inertia here is *de facto* endorsement ... but few will be able to do so convincingly.

Another area where the NIC regime would merit further consideration is the continuing exclusion of those above the state pension age. With the increasing number of people working well beyond this, perhaps it is time to consider lifting the contribution exemption to those over 75 or having a reduced level of contribution for them.

**“ There is another area that is ripe for change, namely the taxation of earned income generally. ”**

## Taxation of earnings generally

Before reverting to Mr Taylor's initial conclusion that businesses are using self-employment rules to avoid tax, there is another area that is ripe for change, namely the taxation of earned income generally.

Putting aside for a moment all the good reasons explaining why we have a situation where labour income derived from an employment is treated differently from self-employment, and workers who are employees in all but name can tax-efficiently cloak themselves with a corporate disguise, I would like to pursue another strand of my thinking in this area.

In my opinion, a person paying for labour invariably knows what is being received in return. This seemingly obvious point is important because what follows assumes that any business entering a contract under which payments will be made will have no difficulty in recognising the facts of any given situation. Those facts will be in plain sight when entering into the contract in question such that the party making the payment will know whether it is a labour income payment or something more than that. Holding this thought for a moment, in these times of the 'gig economy' and short-term contracts rather than permanent jobs it must make sense to abandon the distinction between the treatment of the self-employed and employees or directors, however engaged. Imagine if all sources of earned income were taxed uniformly in the hands of the individual.

## Taxing labour income

It cannot be beyond the wit of Treasury officials to devise a simple, straightforward system whereby individuals paid for the labour they provide will be taxed identically whether self-employed or not. The NIC liability for the employed and self-employed could be identical too, enabling the Class 4 NIC levy on the self-employed to be abolished and aligning the benefit entitlement of all workers. If this is not possible, perhaps the personal allowance of the full-time self-employed could be increased to allow limited financial compensation for the continuing distinction. For example, there could be uniformity of tax and NIC treatment if a contractor is hired to carry out a six-month contract by BigCo plc regardless of whether under the arrangement they are an employee, a self-employed consultant or their services are provided through a limited company (or a contrived agency company).

Of course, there may be difficult issues to be addressed – and many will argue for the status quo. That said, and given the current state of affairs in this area, one could argue without too much difficulty that almost any new overarching scheme such as is being suggested here and which addresses the taxation of payments giving rise (directly or indirectly) to labour income in the hands of the person providing it, will prove to be more equitable than the current system.

I recognise there would have to be provisions to allow a distinction between payments to a business for a service, say global marketing services, where the payments in question might be confused with a labour-only situation, but this should be easily achievable. Broadly, if all that was being provided under a contract was shown to be a single resource, being that of the labour of one or more individuals, the suggested new regime would operate. However, if it could be seen that payments under the contract enabled the business not only to take advantage of the skills of particular individuals but also to draw on the further resources of their employer organisation – and the payment to be made were not therefore 'labour-only' – a different stance could be taken. Admittedly, the legislation covering this would be tricky, but in practice most people would have no difficulty in recognising a labour-only arrangement.

Under the new system described above, the IR35 provisions would become irrelevant, as would the various dubious 'employer' companies that exploit the system. Equally, there would still be a place for companies that operate as a genuine agency finding work for workers and retaining PAYE and NICs as required by law. Imagine the savings in resources for both industry and government.

## Reverting to Taylor's conundrum

So let us assume that all business activity is liable to the BPT (with all distributions taxed under the BDT) and, coupled with the foregoing, all payment giving rise to labour income (directly or indirectly) is treated the same for the purposes of NICs. In that scenario, the current attractions of contrived self-employment and personal service companies would be substantially diminished, if not abolished.

Other issues would need to be addressed, but there might be other simplification opportunities. Capital allowances and the running costs of cars could be scrapped, whatever the status

of the user. Each car could be given a 'tax allowance rating' to determine the tax relief available in respect of the business use of the vehicle in question. Alternatively, the current flat rates could apply across the board. A reasonable allowance would produce a reasonable solution, and in this digital age it is easy to keep precise business mileage records.

Similarly, employees' expenses claims could be abolished. Instead, the test would be driven by the employer discharging or reimbursing the cost. It would be down to the employer to demonstrate that the expenditure made good to the employee was incurred wholly, exclusively and necessarily in the performance of the duties of the employment – otherwise the employer would be required to apply PAYE and NICs to the amount. Expenditure incurred by an employee, but not made good by an employer, would not be taken into account for tax purposes. Yes, there would be a few losers. The benefit-in-kind regime for the provisions of cars and the like would continue, but the employer's only deduction would be the car-specific mileage allowance referred to above.

Given such a scenario, labour-only payments directly or indirectly to workers would attract an income tax deduction (possibly at a rate to be agreed on an individual basis using a code number) and NICs would apply. If such payments were to be taxed in a like manner – whether made to an employee, a consultant or through a corporate structure – contrived arrangements would be less attractive because the current distortions are ironed out. The administrative consequences of coping with and accounting for the requirement to deduct tax and NICs from all labour-income payments cannot be ignored, but will they prove that significant in this increasingly digital age?

By bringing about such a level playing field on which the tax and NIC outcome of income derived from labour would be identical or nearly identical irrespective of the arrangements entered into, the government would be leaving it to business to decide how to engage with workers without creating the distortions that now exist.

The position of employment rights could be addressed too, although recent decisions of the courts may make changes in this area unnecessary. As an aside, one point merits airing. If a situation were to be created whereby it would be fiscally neutral to both sides – in other words both for the person engaging the labour and the intended provider – would not the message being conveyed to any person contemplating joining a particular workforce be either:

- we are keen to use your talents, but don't wish to provide any worker rights such as paid holiday or employment protection; or
- we are keen for you to join our workforce as an employee with all the associated benefits?

## More steps in the same direction?

Other labour-related changes could be contemplated as well. Consideration could be given to permanently excluding expenditure on labour if the payments fall short (at the time of payment) of the minimum pay/national living wage regulations. The cost of losing tax relief on the gross payment (and any

associated NICs) could greatly exceed the penalties being levied under these regulations.

Similarly, payments to illegal workers could be excluded from being deducted in arriving at the taxable profits of a business. Employers can already face heavy penalties if they are found guilty of employing someone who they knew or had 'reasonable cause to believe' did not have the right to work in the UK. Why should such illegal payments be tax deductible?

The tax returns for every business could contain a statement confirming that all remuneration claimed as a deduction satisfied the minimum pay or national living wage regulations and that no payments were made to illegal workers. But think a little further. If it is government policy to encourage businesses to be good employers, would it not make sense to consider permanently excluding expenditure when calculating business profits if the payments gave rise to labour income in the recipient's hand on which PAYE had not been deducted? What further encouragement need be required for 'employers' (however labelled) to treat 'employees' (however labelled) as employees?

**“The government would be leaving it to business to decide how to engage with workers.”**

## Conclusion

It almost goes without saying that any new approach to the matters raised in this article will give rise to many more points than could be covered here. The tax treatment of labour-related payments would be much less of a topic in practice if there were a uniform way of taxing labour income – or, as we called this in days gone by, earned income. Making all income (other than pension income) liable to NICs – whether viewed as investment income or not – seems to me to be just common sense.

Go on, Mr Taylor, take the bull by the horns and get things sorted for the 21st century. Start with this article; I have done your job for you.

Readers are invited to study the above suggestions to identify problems or shortcomings in the ideas floated. Comments or objections on how the tax system could be made both more workable and equitable can be added to the foot of this article on the *Taxation* website ([tinyurl.com/j63dy94](http://tinyurl.com/j63dy94)). Surely it is time to take these matters seriously and to stop just tinkering around the edges of the problem. Views would be very welcome on the points raised. Why, as a matter of principle, should different ways of working not be taxed uniformly and why should NICs not be geared to taxable income regardless of its nature? ■

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