WHY TAXING THE MICRO-BUSINESS IS NOT SIMPLE — A CAUTIONARY TALE FROM THE ‘OLD WORLD’

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This article tells a cautionary tale of the pitfalls surrounding small business tax policy, illustrated with some examples from the United Kingdom. The heterogeneous nature of the small business sector makes it unlikely that tax reliefs and incentives based purely on size will be well targeted. Many small firms are not entrepreneurial and do not wish to grow but it is nonetheless predictable and rational for them to seek to take advantage of any tax incentives made available on the basis of size or legal organisational form. In addition, tax policy that concentrates on the provision of incentives for small firms is likely to result in complexity, the proliferation of thresholds and frequency of change, the costs of which may well outweigh any advantages to the smallest firms. The compliance costs resulting from taxation are regressive, but so too are the costs of dealing with special reliefs. A central problem relates to the drawing of a line between income from capital and income from labour for tax purposes. In seeking to do this, the tax system needs to have regard to legal as well as economic realities. Small business tax policy needs to be based on a better understanding of the way in which businesses form and develop and their motivations and difficulties. Stability and predictability may be more important than special reliefs.

I INTRODUCTION TO THE TALE

According to Wikipedia, a cautionary tale is told to warn its hearers of a danger. The encyclopaedia states that there are three essential parts to a cautionary tale — ‘First, a taboo or prohibition is stated: some act, location, or thing is said to be dangerous. Then, the narrative itself is told: someone disregarded the warning and performed the forbidden act. Finally, the violator comes to an unpleasant fate, which is frequently related in large and grisly detail.’ The encyclopaedia goes on to cite Lewis Caroll in Alice’s Adventures in Wonderland:

Alice had read several nice little histories about children who had got burnt, and eaten up by wild beasts and other unpleasant things, all because they would not remember the simple rules their friends had taught them: such as, that a red-hot poker will burn you if you hold it too long; and that if you cut your finger very deeply with a knife, it usually bleeds; and she had never forgotten that, if you drink much from a bottle marked ‘poison,’ it is almost certain to disagree with you, sooner or later.

Above all, cautionary tales underline the importance of learning from experience and not ignoring the advice of others. In accordance with this formula I am first going to explain the dangers inherent in designing small business policy and, second, how the United Kingdom (‘UK’) government has disregarded all the warnings it should have noted. I shall then relate, although perhaps not in all its grisly detail, what has happened as a result. In expounding this story I shall also refer to other examples of policy makers disregarding dangers. I shall discuss how the unfortunate outcome which has befallen the UK Chancellor, Gordon Brown and his team might be avoided by better behaved policy makers who take more care to listen to advice given. Indeed, to be fair, we shall note how the UK Treasury seems to be beginning to learn from its experience. Finally it will be argued that some radical new thinking may be

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needed but that there must be consultation and testing rather than experimentation on the small business sector.

Much of the discussion here is based on UK experiences and UK statistics, and care must be taken not to imply that the characteristics of small firms and their problems will be identical in all jurisdictions and, even within jurisdictions, across all sectors. Many of the lessons drawn, however, do seem to be relevant more widely and the debates around tax policy making for small businesses in Australia and the United States of America (‘US’) seem remarkably similar to those in the UK.

II THE WARNING — DANGERS INHERENT IN SMALL BUSINESS TAX DESIGN

A The Pitfalls Outlined

There is a tendency to believe that because small businesses do not involve as many people as large businesses and because the sums of money concerned are lower, that their affairs should be simpler. This assumption is mistaken. Micro-businesses may be set up by just one person or they may emerge from acquaintances, friendships, blood relationships and marriage. Since people and their relationships are not simple, micro-businesses, though small, are far from simple organisations. It is unlikely that their tax affairs will be simple either and sometimes attempts to simplify, or to provide relief for small business, can actually create complexity: the concept of ‘complex deregulation’ noted previously by this author in connection with company law. For example, the creation of elections and options for small businesses, intended to assist them, may create expense by increasing choice and the need to take advice. Although there may be a resulting tax saving, this might be outweighed by the fees they have to pay to advisers and the management time taken in learning about and considering the available elections.

In a tax context, we might extend this concept to one of ‘complex simplification’. This is related to a phenomenon that has been noted in connection with tax simplification by Steven Dean of Brooklyn Law School: that of ‘attractive complexity’. Dean’s argument is that relying on taxpayer preferences to guide simplification efforts may produce forms of deregulation that are not simplifications at all. The example he gives is that of the check-the-box entity regime in the US which resulted from taxpayer pressure and may well have been popular as a means of reducing tax burdens, but which most certainly has not produced tax simplification, but rather opportunities for more choice and manipulation. Similarly, small business pressure groups might lobby for forms of relief but find that they do not ultimately produce simplification, as in the case of the ill-fated nil rate of corporation tax in the UK, now repealed. This is the subject of further discussion below.

This paper will focus on micro-businesses (defined here as businesses with fewer than 10 employees) because the arguments are most marked in relation to them — their profits may be very low indeed and by definition there are few people involved but they are far more complex in the issues they raise than many would predict from those facts.

The main causes of complexity can be classified as follows:

1 The desire to achieve a range of objectives through taxation — not only revenue-raising, but also micro and macroeconomic management. The objectives of different government

departments may conflict and policymaking may not be ‘joined-up’ due to lack of communication.

2 The failure to understand the nature of the micro-business as distinct from the small business, including the failure to recognise the motivations for setting up such a business. Business organisations often represent the larger small businesses for the simple reason that micro-businesses are by definition non-joiners of organisations. Complexity may be more attractive to larger small firms than to micro-firms because they may have more to gain, but there will be losers as well as winners from such ‘attractive complexity’.

3 The existence of many different legal forms for small businesses which may be adopted by micro-business and the fact that there may be commercial or legal (for example, employment law) reasons why one of these is preferable to another. There are also family and other personal relationships interacting around the micro-business, which may complicate the picture.

4 The failure to appreciate the regressivity of compliance costs and to ‘think small first’. This may be a more layered problem than is fully appreciated: burdens are not always considered in a joined-up way. For example, removal of a tax accounting requirement may not assist, and could even hinder, if the requirement exists anyway for corporation law or commercial reasons.

5 The proliferation of different size thresholds for different purposes. Thresholds may create barriers to growth and increase compliance costs at the borders. Deregulation and reliefs may increase complexity to give ‘complex deregulation’ or ‘complex simplification’.

6 The inclination to change regimes frequently, often with well-intentioned aims, but failing to appreciate the cost of change. This is coupled with an underestimation of the importance of stability to the micro-business. Stability is important to the business community generally but even more so to micro-businesses because of the regressive costs of change and learning new systems and rules.

B The Pitfalls in More Detail

Each of these causes of complexity is contentious in some way and so more detailed discussion and justification of the argument that these are ‘pitfalls’ is required.

1 Diverting from the Primary Objectives of Taxation

Whilst the purist might argue that taxation should be used only for revenue-raising, it is a fact of life that governments will also wish to use the tax system to manage the economy at both a macro and a micro level. Governments seem particularly inclined to attempt to use the tax system to create special incentives and relief in the case of small businesses. The two key justifications for this are that there are market failures created by the power of larger firms, asymmetric information, financing difficulties and market barriers and that there are structural costs of being small, such as lack of ability to set off losses against profits elsewhere and, generally, the regressivity of tax burdens. In addition, the importance placed on small businesses in terms of the economy and job generation are frequently relied upon to justify tax provisions targeted at small businesses.

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6 Dean, above n 4.
7 Freedman, above n 3.
Although there may be justifications for special small business tax relief, they are not always made clear and sometimes this rationale has not been carefully applied. In addition, even where the rationale is applied, in practice the different forms of relief are often badly targeted. A further problem is that incentives can often be used by businesses that the legislature did not originally intend to benefit. This will then be described as avoidance or even abuse by governments, although arguably it is simply a rational reaction to the structures created by the legislation. Even if the targeted firms are the ones to benefit, this may distort the market in unintended ways by, for example, resulting in the allocation of resources to small firms in circumstances where larger firms could use them more efficiently.

A report on best practice by the OECD points out that a tax paid by small business will rarely coincide closely with the target group — that is the tax, be it personal income tax, corporation tax, or general consumption taxes, will affect a much wider group. There is no such thing as a small business tax per se. Of course this is dealt with often by recreating subgroups for tax purposes but this creates new thresholds and thus barriers and complexities. As the OECD points out, this lack of precise targeting of tax-based measures must be measured against the attractions of using existing administrative machinery. The report lists the following as areas where the tax system has a potential role: limiting the cost disadvantages faced by small businesses in complying with tax legislation; encouraging the creation of new small businesses; ensuring the continuation of small businesses when control passes from the founder of the firm to another person.9

2 The Nature of the Micro-Business

The aim of small business tax relief is generally to encourage the growing, rather than the static, small business in order to encourage job creation and economic growth.10 The very smallest firms may be start up firms which intend to grow — equally they may be small because they like it that way, known as ‘life-style’ businesses. For many small business owners the motivation to set up their own business is to escape bureaucracy, to balance work and family responsibilities and to obtain autonomy. They are often reluctant to grow and in particular, reluctant to take on employees.11 Research has shown consistently that only about half of small businesses wish to grow12 and the larger the small business the more likely it is to want to grow.13 The UK Small Business Service’s 2004 Annual Small Business Survey states that only 11 per cent of small businesses14 consider themselves to be prevented from growing when they wish to do so. Many of these businesses which do not wish to grow can be considered life-style businesses. The need to make a profit is not irrelevant since obviously few businesses can survive if they do not do so, but many of these businesses also have other measures of satisfaction and criteria for assessing whether their business ventures

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13 Defined in that survey as businesses with zero to 249 employees.
are successful. Personal satisfaction, pride in the job and a flexible lifestyle may be valued more highly than wealth creation.\(^{15}\)

Relief targeted to the very bottom end of the small business sector, whether by number of employees, turnover, profit or some other measure, will catch both these groups indiscriminately and so, for governments wishing to promote growth, will have a deadweight cost. Although there is an increasing volume of research on the characteristics of small businesses and, in the UK, much of this is government sponsored and published by the Small Business Service, there has been a failure in recent years by the Treasury and Inland Revenue to take this information on board when engaging in tax policy design. There are welcome signs in the latest pre-budget review that this may be improving, in part perhaps as a result of the creation of a new and strengthened tax policy function in the Treasury following a recent review of the UK revenue departments.\(^{16}\) Encouragingly, the announcement by the Australian Board of Taxation that it is undertaking a scoping study of tax compliance costs facing the small business sector states expressly that it will work closely with small business and especially micro-business in undertaking the study.\(^{17}\)

Micro-businesses matter. They make up the majority of all businesses in number of enterprises (although not of course in terms of employment or contribution to the economy). In the European Union in 2003,\(^ {18}\) 92 per cent of all enterprises were micro-enterprises under the definition given above.\(^ {19}\) They lag behind in terms of value added per person occupied, but nevertheless employed an average of three people per enterprise, although half of these micro-enterprises had no employees at all.

There is a similar picture in the UK statistics. At the start of 2004, there were an estimated 4.3 million business enterprises in the UK, about four million (93 per cent) of which were micro-businesses. 3.1 million (72.8 per cent) had no employees at all. Micro-businesses accounted for around 33 per cent of total employment and 23 per cent of turnover.\(^ {20}\) Although clearly each micro-business on its own is less significant and may even be less efficient than any single small, medium or large business, on no measure could micro-businesses be considered unimportant as a sector. It is also clear, however, that this sector will include a great variety of businesses with different motivations so that it is necessary to look at the range of types of businesses being dealt with.

If tax systems are being designed to create incentives to grow, for example, then it is likely that those incentives will only operate in the way intended in relation to businesses which want to grow in the first place. Other business owners might take the benefits of the incentives without having any intention of growing. The fact that wealth creation is not their only motivation and that they do not wish to grow does not mean that they will not take advantage of any means of cutting the tax cost which is offered to them. This might be argued to be an unintended consequence. Sometimes unintended consequences are inevitable and difficult to avoid, but in this case the consequences of offering tax breaks to all micro-businesses is predictable. The breaks will apply to as many firms that do not wish to grow as to those that have a growth orientation.

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\(^{15}\) Walker and Brown, above n 11.


\(^{18}\) Nineteen countries at that time (including European Free Trade Association countries).


3 Existence of Different Legal Forms

The ingenuity of lawyers in devising legal forms for the purpose of doing business has created concepts of major importance without which business as we know it would not operate, in particular limited liability. At the same time, this ingenuity creates complexity for the micro-business since one of the first decisions that a person setting up in business has to make is what legal form to adopt. To an economist, incorporation implies a separation of capital from labour and management from control. The corporate legal form is structured for this purpose but does not require it. Because shareholders, directors and employees may be one and the same people or even one person, the legal form does not necessarily result in such a separation. The UK system of business organisations encourages incorporation by making it cheap and easy. This is an explicit policy of recent company law reform enacted in the Companies Act 2006. In a guide to the new legislation for small business, the government states that ‘[t]he purpose of company law and corporate governance is to promote enterprise and stimulate investment. We are determined to ensure that our system makes it easy to set up and grow a business’. 21

Leaving aside whether this is an adequate description of the function of company law, it is certainly indicative of the widely held belief that encouraging incorporation encourages enterprise and growth. It is clearly important not to put barriers in the way of those needing to incorporate but whether incorporation should be encouraged is another matter. Of course, a growing enterprise will eventually need some kind of mechanism for organising its business and procuring limited liability but it does not need to be incorporation. In Australia, business trusts are widely used although they usually use incorporated companies as part of the arrangements. In the US there are more legal forms available, notably the limited liability company (‘LLC’), although the proliferation of legal forms there is beginning to be seen as problematic. In the UK the recently created limited liability partnership (‘LLP’) has been seen by some as a potential vehicle for small firms but that was not the purpose for which it was designed and it is not entirely suitable for this purpose. 22 The tax advantages of incorporation in the UK have been amongst the factors limiting the development of the LLP for small firms to date. Incorporation can prove costly eventually and may be a poor idea if the owners do not really understand that they are creating a separate entity. The advantage of limited liability may be illusory as may other supposed advantages of incorporation such as the ability to raise finance more easily where the firm is in fact very small. 23 Yet UK government policy is to encourage incorporation for even the smallest businesses whereas in the case of taxation, as we shall see, incorporation of the very smallest firms may be seen as an abuse in some circumstances — a rather confusing picture for a small business owner and not the stuff of joined-up government.

Whilst some research suggests that incorporated businesses are more likely to grow than those which are unincorporated, 24 it does not follow that incorporation is a contributory factor

24 David J Storey, Understanding the Small Business Sector (1994), 140. Note that this is based on research undertaken before incorporation was made more attractive for very small companies by changes in the tax system. In addition, Storey refers to an empirical project undertaken by this author which found 40 per cent
in growth — those who choose to use incorporation may be at a certain stage of the business cycle or may be better advised or more motivated in the first place. Targeting tax relief to incorporated as opposed to unincorporated businesses will not result in that relief reaching only businesses that grow or wish to grow. Implementation of such relief will change behaviour and thus change the set of businesses incorporating so that it begins to include more businesses which do not wish to grow.

Neutrality in the tax system as far as choice of legal form is concerned is an obvious desideratum but this is very difficult to achieve because incorporation has a degree of legal substance which makes companies genuinely different from unincorporated firms in terms of consequences for the parties concerned. Very often, the concern is that incorporation increases tax due to the element of double taxation on corporations.\textsuperscript{25} In the case of the micro-business in the UK the issue is rather different and arises from the fact that business income, labour income and income from capital are separated from each other in what may seem to be an artificial way but which is a natural consequence of the rights and duties created in law.

Short of a complete move away from income as a tax base, which is outside the scope of this paper,\textsuperscript{26} this could be dealt with in various ways. First, income from capital and income from labour could be taxed identically. Unless owner controlled firms can be dealt with differently from others, this is unlikely to occur, due to the mobility of capital which is forcing down tax rates on returns from capital globally although the differences could be reduced. Owner controlled companies could be taxed as if they were unincorporated\textsuperscript{27} but attempting to do this would give rise to serious definitional problems. The aim would be to differentiate companies where the owners could adjust the amount paid out by way of salary and that paid as a return of income from those which could not but this is not going to be an easy dividing line.

Second, the tax legislation could look through the corporate veil by treating returns on capital as employment income in some circumstances — the difficulty here again is definitional as it is necessary to define those circumstances. This is a problem the UK has encountered, as discussed below.\textsuperscript{28}

A third way of achieving a measure of neutrality might be by treating an unincorporated business as if it had some kind of separate entity status so that the labour income of such a firm was taxed in a similar way to returns on capital but employment income would continue to be taxed differently. That exchanges one distortion for another and provides an even greater incentive than now to convert employment into self-employment. The President’s Advisory Panel in the US has recommended a greater separation between business and personal income for unincorporated firms in its Simplified Income Tax Plan but this seems to


\textsuperscript{26} That is, a move to consumption taxes for individuals and businesses. Even in such a system, it is still necessary to allocate the tax base to different legal persons.

\textsuperscript{27} Tax Faculty of the ICAEW, Small Companies, the Self-employed and the Tax System, TAXREP 22/05 (April 2005).

\textsuperscript{28} The so-called ‘IR 35 legislation’, For a scheme used in the Nordic countries to deal with the same problem, see Peter Bireh Sorensen, ‘Neutral Taxation of Shareholder Income’ (2005) 12 International Tax and Public Finance 277.
be largely intended as an administrative measure, and one of doubtful efficacy since it is hard to see how the separation would be defined and policed.  

A further reason for the complexity of different legal forms of micro-firms is that they interact with the underlying personal relationships. A business partnership may exist between friends or a married couple. Profit splitting and allocation of interests in capital may occur in a non-commercial way and this will exacerbate the difficulties created by the differences in taxation of labour and capital.

4 Regressivity and the Removal of Burdens

All businesses complain of complexity but it has been clearly established that administrative burdens, especially those in the area of taxation, are regressive in nature. Compliance costs are regressive, especially where a Value-Added Tax (‘VAT’) or Goods and Services Tax (‘GST’) is involved. Thus small businesses are at a disadvantage.

Governments recognise that the administrative burden of taxation on small businesses is one of the most serious areas of complaint and take seriously the need to reduce such burdens. Both the UK and Australia are currently consulting on compliance costs of small businesses. Consideration of burdens as if they were distinct from the substantive law is not, however, likely to help significantly and the starting point needs to be the underlying policy of the law.

The regressivity of compliance costs is the result of diseconomies of scale, the complexity of the tax system and the learning curve necessary for acquiring the knowledge to deal with that system, especially if it changes frequently. The best way to assist small businesses will be to reduce complexity but as already shown the micro-business is a complex animal. The mismatch between legal and economic form, discussed above, is a good example of a layer of convolution which may require more complex regulation for the micro-business than for the publicly quoted company. Attempts at providing deregulation or relief can result in increased complexity also if they are not properly thought through. The introduction of elective simplified systems which need to be compared with existing systems to assess whether they will produce a saving are an example of this problem.

Apparent simplification that only pushes cost elsewhere can also be a problem. Removal of a reporting requirement, for example, could prove costly if the information no longer stored or the analysis no longer required is found to be necessary at a later date. In this sense the tax system could have a role in underlining good practice and too much simplification might not be helpful.

Some measure of regressivity is inevitable and compliance costs will always be a problem for the micro-business. It may nevertheless be more efficient for the small business to deal with certain matters of which it has close knowledge than it would be for the revenue services to administer these matters, for example payroll taxes. The market may often come to the rescue here by providing composite services which can be used by the small business sector.

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29 The US President’s Advisory Panel, above n 25. The recommendations consist of a Simplified Income Tax Plan and an alternative consumption tax plan — the Growth and Investment Tax Plan. The small business implications of these plans are discussed further below.


But there are instances where the compliance costs are a result of unreasonable off-loading of work by the administration where there is no obvious link between the taxpayer’s business and the work to be done. In such instances it will make more sense for the revenue to bear the administration costs. This has now been recognised in the UK by, for example, the removal of administration of the Working Tax Credit from employers to the Government, announced in the 2005 Budget. Despite earlier insistence that it was important for this credit to be clearly linked with work through the pay packet, consultation forced the Treasury to remove this burden from small business after just two years.

5 Proliferation of Size Thresholds

Unless relief is of a kind that can be made available to all, it needs to be targeted. It may be that different forms of relief will need to be targeted in different ways — it makes sense for a VAT relief to be related to turnover but an income tax relief to be related to profit. However, this will result in a wide variety of thresholds that will leave the business owner confused and possibly also deterred from growth rather than encouraged, since she or he may not wish to cross a threshold and face a jump in tax liability. Coleman and Evans have called for greater definitional consistency where possible as a means of reducing compliance costs. The proliferation of tests has been noted as a characteristic of systems in the US and Australia as well as the UK. Wherever possible, thresholds should be harmonised and new thresholds should be considered in the context of existing ones. If there is a need for different thresholds for good reason, the rationale should be clearly considered.

In a report prepared for the Institute of Chartered Accountants in Australia, Warren, Payne and Hodgson argue that small business definitions should be collected into one piece of legislation so that business and their advisors can view all concessions together and that parliamentary attention should be drawn to deviations in definitions so that such definitions would need a clear justification. This would be a useful procedural and administrative improvement but, going beyond these terms of reference and into substance, it could be argued that, if a relief is worth giving, serious thought should be given to whether it could be given across the board to all business to prevent a barrier effect. This will not always be appropriate, but where a relief is unlikely to be one that larger businesses will opt for or benefit from, it may do no harm to make it available generally to prevent a sharp cut off line. A non-tax example is the corporate financial audit. Arguably the limit for requiring a mandatory audit could be set quite high because any serious businesses wishing to borrow or transact major business will probably to be able to produce an audit report on a voluntary basis anyway. Application of this principle may be more difficult in a tax context but is worth considering in particular instances.

6 Frequency of Change and the Failure to Understand the Importance of Stability

All taxpayers desire stability and certainty but it is recognised that there is a trade off between certainty, fairness and responsiveness. Because change is so costly for micro-business due to the learning curve and general regressivity of administrative burdens, successive attempts to improve fairness by fine-tuning may not be appreciated as much as governments expect them to be. Frequency of legislative change has been identified as a prime cause of high compliance costs.

33 Ibid.
34 See the separate contributions of Stewart Karlinsky and Garry Payne to Warren, above n 8.
36 Evans, above n 30, citing Sue Green, The Institute of Chartered Accountants in England and Wales, Compliance Costs and Direct Taxation (1994).
It may be that there are circumstances in which business would prefer to live with a less than perfect provision on the basis that a fairer or more precise provision would be more costly to operate. The costs of change per se need to be taken into account in policy making. The temptation to keep inventing new schemes needs to be avoided. The Chartered Institute of Taxation make this clear in their response to the 2005 Consultation by the Inland Revenue and Customs and Excise (now HMRC) on the administrative burdens of the tax system on small businesses. In response to the question, ‘What might enhance the existing range of VAT simplification schemes available to small businesses?’ they state ‘there are those amongst us who feel that the question posed here is the wrong one. Stability is more important than more simplification schemes and simplification of the system is more beneficial than more schemes to counteract the complexity.’ Here is a direct example of practitioners on the ground resisting what has been called above complex deregulation or even complex simplification. Previous lobbying has produced a form of Dean’s attractive complexity which consists of an array of small business VAT options, most of which have a low take up rate. Deciding whether to opt for them itself creates cost. For example, the flat rate VAT is used generally only if it will produce a cost lower that using regular VAT accounting, which requires advisers to work the figures for both methods so that there is a compliance cost rather than the intended saving. This comment suggests that these small business advisers at least recognise the downside of adding so-called simplification schemes rather than eliminating choices.

III FALLING INTO THE TRAPS — SOME CASE STUDIES

Recent experience of small business taxation policy in the UK may be used to illustrate a number of the above points. Whilst some of the damage done has recently also been undone, this undoing has itself been potentially costly since it involves change. Other issues remain in doubt and there is a sense of uncertainty. Generally there is not a good relationship between small businesses, especially the micro-business sector, and government due to the series of measures introduced over the past few years. Although the number of small business owners is far smaller that the number of employees, the small business owning taxpayer has a strong voice and the expressions of discontent over their tax treatment has been vocal beyond their number.

A Corporation Tax Rates

The prime example of bad policy making for small business in the UK has been the introduction of a zero rate band for incorporated businesses. This illustrates an attempt to stimulate growth through taxation which was not well targeted and which therefore failed. This error also resulted from a failure to understand the way in which the legal form of small business worked. There was a failure to differentiate small and micro-businesses. In addition, the attempts to counter the effects of the failure layered a complex so-called ‘anti-avoidance provision’ over the top of the relief. Even those benefiting from the relief were then involved in cost and complexity. By the time both the relief and the anti-avoidance provisions were abolished in 2006, the small business community was so pleased to see the back of the complexity that there was no outcry at the disappearance of the relief even though it only

37 Chartered Institute of Taxation response to UK IR and HM Customs and Excise report, above n 31.
38 UK IR and HM Customs and Excise, above n 31.
39 There is a great volume of literature on the general subject of discontent in the practitioner journals and also on websites. For examples see Mike Truman and Francesca Lagerberg, ‘Am I bothered?’ Taxation, 8 December 2005; <http://www.shout99.com/contractors/index.pl?n=10>. See also Anne Redston, ‘Small Business in the Eye of the Storm’ [2004] British Tax Review 566.
brought everyone back to where they were four years previously — indeed it was generally welcomed.40

The changes that occurred over the four years from 2002 to 2006 have created expenses for businesses which had incorporated and were now not going to benefit as much as they had previously believed. There can be tax penalties on disincorporation. The pace of change has left small business owners confused and bemused, especially as they have been berated as tax avoiders, whereas as far as most of them were concerned they were simply following their accountants’ advice to take up an incentive offered to them by government.

The nil rate was introduced in 2002 and its removal announced in the Pre-Budget Review of December 2005. There is little or no dissent from the view that this was a failed experiment. The introduction of the nil rate in 2002 was followed by behaviour which all taxpayers and their advisers saw as both rational and entirely predictable but which government preferred to consider an ‘unforeseen consequence’ and a form of tax avoidance. In other words, businesses incorporated to obtain the tax benefit of the zero rate even if they did not intend to grow. In terms of predictability, this seems to fall into the category of red-hot pokers burning people. Alice would not have been surprised.

The problem was pointed out by the Institute for Fiscal Studies41 and others and highlighted in the Standing Committee debates on the 2002 Finance Bill.42 Nevertheless the Government persisted with this policy. Speaking in the House of Commons Standing Committee on introducing the measure, the Paymaster General explained the government’s thinking: ‘The measure recognises that businesses growing beyond a certain size will often be companies. We believe that cutting corporation tax is an effective way of targeting support at small and growing businesses’.43

As discussed above, there is a fallacy in the argument that because the relief was targeted at companies and because companies are more likely to grow than unincorporated firms it would be primarily growing businesses that were targeted. Although the Treasury had, according to the Paymaster General, taken account of the effects of the new relief on behaviour, they do not seem to have understood the flexibility of legal form and the ease with which any business could become a company. Thus, the Paymaster General, presumably briefed by her officials, stated:

Some 78 per cent of businesses are unincorporated despite the fact that there are already theoretical tax benefits for incorporating... There is no shortage of tax advisers seeking to earn a fee from advising companies that that is the best way forward, but we have still not seen that change... We are convinced that the balance is right...Surely small businesses will not look a gift horse in the mouth, We want to create growth and economic activity, and to sustain entrepreneurial activity.44

They soon saw the change and small businesses were not slow to respond to the gift horse. The zero rate was introduced for companies with a profit of £10,000 or less. Beyond that, there was a tapering relief for companies with profits up to £50,000 at which point the formula operated to ensure that the entire £50,000 was subject to tax at 19 per cent. The 19 per cent relief remains for companies with profits up to £300,000. For a company with profits

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40 Indeed, these changes had been proposed by several small business organisations, including the Forum for Private Business, which pointed out that the compliance cost of the anti-avoidance provision outweighed the savings from the nil rate — see the Forum’s key recommendations within the Pre-Budget Report, November 2004. See also Alan Southern and James Meyrick, Small Business Research Trust, Owner-Managed Businesses and Their Tax: An Interim Report on the Views of Small Businesses (2004), although their results seem equivocal: possibly those questioned were rather confused, or comprised a skewed sample, or both.


42 UK Parliamentary Debates, House of Commons Standing Committee F, 16 May 2002.

43 Ibid c 114.

44 Ibid c 115.
between £300,000 and £1.5 million there was (and still is) marginal relief until the full rate of 30 per cent is reached at that level.

Although the £10,000 profit limit was very low it could be achieved in more cases than might be expected through the use of salary payments to family members as well as other deductions. Salaries must be paid ‘wholly and exclusively’ for the purpose of the trade of the company to be deductible.\(^45\) This has not, in the past, frequently been the matter of investigation unless payments are exceptional, although this may be changing. Such salaries are, of course, subject to income tax and National Insurance Contributions (‘NIC’), but if kept low and paid to family members with no other income who are on low or nil rates of tax, savings can be made. Combined with the fact that, following the abolition of advance corporation tax, dividends carry a tax credit even if paid out of profits which have not been taxed, this was an effective and completely legal tax planning route.

Many very small self-employed taxpayers were advised to incorporate and incorporations rose dramatically. There were 222,000 incorporations in 2001, 293,000 in 2002 and nearly 397,000 in 2003.\(^46\) The Treasury began to worry. In 2004 it decided that the loss to the Exchequer was too great and that action must be taken. The obvious action would have been to abolish the nil rate but this would have involved loss of face. Therefore the Non-Corporate Distribution Rate (‘NCDR’) was introduced.\(^47\) According to the Regulatory Impact Assessment which was used to introduce it, the measure was necessary to ‘focus tax incentives for business where they are most effective to support enterprise and growth’ and to ‘discourage businesses from incorporating solely or mainly for the tax and NIC advantages without changing their economic activity’.\(^48\)

Needless to say, the NCDR rate involved long and complex legislation (six dense pages) relative to what was to be achieved. Effectively, where distributions were paid out of profits taxed at less than 19 per cent the NCDR increased the corporation tax rate to 19 per cent on that amount of the distributed profits thus negating the advantage of the nil rate for the vast majority of micro-firms which make small profits and whose owners need to draw them all in order to live. In the process, legislation was introduced which was described by one commentator as bordering on the surreal.\(^49\) Once this kind of legislation is introduced, the ‘tax planning’ mind instantly turns to ways in which it might be avoided and groups of companies might be used, although the amount to be gained would make it hardly worthwhile. Nevertheless legislation was needed since there was an obvious loophole. The compliance costs created by this legislation and the learning curve for advisers was quite disproportionate but the Government response was initially that the tax profession had brought it on itself and its clients by advising the small businesses to incorporate. Not surprisingly in the light of Dawn Primarolo’s earlier reference to gift horses, the small business community was not impressed.\(^50\)

It is to the credit of the new team at the Treasury that this rather silly business was cleared up in the 2005 Pre Budget Report proposals, by the simple device of removal of both the nil rate and the NCDR. Although obvious, this must have taken some doing with the politicians,\(^45\) Section 34 Income Tax (Trading and Other Income) Act 2005; Copeman v William J Flood & Sons [1941] 1 KB 202; Mallalieu v Drummond [1983] 57 TC 330.
\(^49\) Ball, above n 47.
\(^50\) Eg David Rae, ‘Small Companies Tricked into Tax Trap’, Accountancy Age, 20 February 2004.
but there has been relatively little crowing since everyone is so relieved. The Regulatory Impact Assessment,\textsuperscript{51} however, has a touch of \textit{Yes Minister} in its language when it states:

This measure aims to promote growth of small businesses through better targeting of tax incentives and by simplifying the corporation tax structure to minimise compliance costs and allow firms to focus on growing their businesses.

Gordon Brown, Chancellor of the Exchequer, when announcing this move in his Pre-Budget speech was careful not to repeat the error of suggesting that the small businesses incorporating were themselves tax avoiders but instead cast the stone at their advisers, saying: ‘I am closing a relief under which, for tax reasons only, people are being persuaded without changing what they do to set up a company’.

This is an extraordinary statement from a government which was trying to do the persuading and shows a fundamental misunderstanding of what it means to incorporate, given that it is well established that incorporated and unincorporated businesses may have identical underlying economic activities although in a legal sense people do change ‘what they do’ when they set up a company because they alter their rights and duties.

The Regulatory Impact Assessment acknowledges that the change is a response to requests from the small business community to the Treasury’s earlier paper \textit{Small Companies, the Self-Employed and the Tax System},\textsuperscript{52} but notes there was no consensus on future developments as a result of the extensive consultation that followed this paper. Thus we are back to square one although the quid pro quo from government for removing the nil rate was to increase first year capital allowances (depreciation) for small businesses from 40 per cent to 50 per cent for investment in plant and machinery made in the year April 2006.

I have dwelt on this example because it is hard to find another that is quite so clear a cautionary tale about the consequences of ignoring good, common sense advice. Do not ignore the significance of legal form or think that incentives can easily be targeted. Companies are no different from unincorporated firms in this unless they wanted to grow in the first place when the company law and commercial advantages (such as the availability of floating charges as a form of finance) may assist them to grow. People will react to tax incentives by changing their behaviour. Most small businesses are micro-businesses and most micro-businesses are not in the business of growing. Bolstering indiscriminate forms of relief with provisions to cut them down creates complexity in the tax system for all and this increases cost and resentment of the tax system.

B \textit{Status Issues}

The problem of defining self-employment and distinguishing it from employment will be familiar to Australian readers.'\textsuperscript{53} In the UK, the distinction continues to be governed by the old case law.'\textsuperscript{54} The incentives to be self-employed are in part tax based as a result of more relaxed rules on deducting expense for the self-employed but the real driver is NIC, where there are significant savings to be made through self-employment.

1 \textit{Personal Service Companies}

Many micro-businesses provide services rather than goods and the individuals concerned may be hard to distinguish from employees on the traditional tests. Those to whom they

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\textsuperscript{51} HMRC, \textit{Partial Regulatory Impact Assessment}, above n 11.
\textsuperscript{52} See HM Treasury, above n 11.
\textsuperscript{53} In Australia the \textit{New Business Tax System (Alienation of Personal Services Income) Act 2000 (Cth)} introduced a definition of ‘personal services income’ into s 84-5 of the \textit{Income Tax Assessment Act 1997 (Cth)} but the case law distinction remains relevant to the interpretation of this provision.
\textsuperscript{54} For a fuller discussion of these issues see Judith Freedman, \textit{Employed or Self-employed? Tax Classification of Workers and the Changing Labour Market} (2001). http://www.ifs.org.uk/comms/dp1.pdf
provide their services do not wish to engage in the difficult question of whether they are employees — for tax, employment law and other legal reasons they wish them to be clearly providing only services. As a result they encourage or even require these businesses to incorporate. The person supplying the services is still an employee, of course, but he is an employee of his own personal service company (‘PSC’). This opens up opportunities for extracting at least part of the remuneration for the services by way of dividend and so saving on NIC. Income splitting with other family members also becomes possible.

The difficulty here is that whilst some PSC owners are merely disguised employees, others genuinely may be budding entrepreneurs, given the chance, but both types often start off by working only for one client and have some of the common law badges of employment. The government has seen the development of PSCs (which existed well before the nil rate complication described above but was not helped by it) as a form of tax avoidance. From April 2000, special rules for taxing PSCs were imposed.

Once again, this seems to reveal a lack of understanding of the way businesses form and develop. As mentioned, some of these PSCs are nothing but employees seeking to pay less tax but this legal form may encourage even those who start out as essentially employees to start thinking and acting like real entrepreneurs. In any event, the avoidance, if there is such, is not initiated by the workers but by the often larger businesses being serviced in this way. In its original form, this legislation would have imposed a duty on those to whom services were being provided. This might have had a positive social effect in persuading such businesses to revert to straightforward employment, but the superior lobbying power of the businesses soon ensured that responsibility was transferred to the workers. This legislation then made less sense than originally intended but the Government ploughed on with it. Having introduced it, they may have thought that the nil rate for small corporations could safely be introduced because all non-entrepreneurial small businesses would be caught by the PSC legislation. This also reveals misunderstanding, since not all non-growing, micro-businesses have the characteristic that they are disguised employees. The rich pattern of different micro-business types was not recognised.

The rules designed to tax PSCs, known as ‘IR 35’ after the number of the press release heralding their introduction, have been met with much discontent and litigation.\(^55\) There was a problem of inequity as between employees and disguised employees to be countered but the broad way in which this has been implemented and the disregard for employment law issues has led to resentment and may mean that workers pay tax as employees but without any of the non-tax benefits. In addition some genuine entrepreneurial activity may be deterred.

The IR 35 legislation\(^56\) subjects the earnings of PSCs and other entities (such as partnerships) to income tax and NIC as if the individual had earned them. The rules apply where a worker provides his or her services to a client who is a business (not, for example, to householders); the arrangements are made through an intermediary such as a company or partnership; and the worker would have been treated as employee of the client for tax and NICs purposes had the arrangement been made between the worker and the client.

Where these rules apply, the client continues to pay the intermediary gross and salary paid by the intermediary to the worker is subject to the Pay as You Earn and NIC rules in the usual way. But to the extent that the intermediary does not pay out its entire earnings as salary, the intermediary is treated as paying a salary to the worker on the last day of the tax year (or

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earlier, if relationship with the intermediary ceases before then). In addition, benefits in kind paid to the intermediary are taxed in the same way as employee benefits. Dividend tax relief is given to prevent double taxation, and a deduction is allowed for expenses of running the intermediary equal to 5 per cent of the receipts from the engagements caught by the legislation. Any amounts spent by the intermediary, which could have been claimed as expenses against income tax had the worker been employed by the client and had paid them himself, can be deducted but only under the more restrictive employee deduction rules.

In determining whether the worker would have been an employee of the client had there been a direct relationship between them, the existing case law that seeks to distinguish the employed from the self-employed is used. This case law is fact-based and lacking in clarity, leaving workers and intermediaries in a state of uncertainty.

The IR 35 legislation falls into a number of pitfalls. It makes no attempt to understand the real motivation of the people using PSCs and also fails to relate the use of the corporate form with action in other areas of the law such as employment law. It is complex and uncertain in its operation, which imposes a cost and burden on a greater number of business owners than are ultimately subject to the provisions, because many people need to seek advice. This is a source of a great deal of angst for business people, which causes considerable annoyance beyond those in fact subject to the legislation. It also creates a great deal of work for professional advisers, but work which they would perhaps prefer not to have as it is not especially productive or lucrative. These advisers should not be let off the hook since they have been happy to encourage incorporation for tax reasons and are also active in creating concern about IR 35 in quarters where there is no need to worry about it, but then none of this is surprising or unreasonable. An adviser who had not advised a client to consider incorporation when the nil rate was available would have been negligent.

2 Income Splitting

A feature of PSCs is that they facilitate income splitting. The IR 35 legislation prevents this but where the legislation is not applicable income splitting remains possible. In Australia, likewise, there is a problem perceived by the Australian Taxation Office (‘ATO’) where Divisions 84 to 87 of the Income Tax Assessment Act 1997 (Cth), which limit alienation of personal services income, do not apply. In Australia, it seems that this may be tackled under the general anti-avoidance rule in Part IVA of the Income Tax Assessment Act 1936 (Cth) (the ‘GAAR’), although there may have been a recent retrenchment of this approach following the decision in Ryan v Commissioner of Taxation.\(^{57}\) In the UK, since we have no GAAR, HMRC has resorted to using anti-avoidance provisions designed for settlements (the ‘settlements provisions’) and categorically not originally intended for this situation.\(^{58}\) This has proved an expensive and confusing experience and the litigation continues in a test case, Jones v Garnett, also known by the name of the company as Arctic Systems.\(^{59}\) A detailed discussion of the settlement provisions analysed in this case is outside the scope of this paper but much has been written and will be written in the future and it raises fundamental issues of principle relating to the micro-business.\(^{60}\)

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58 Formerly s 660A of part XV of the Income and Corporation Taxes Act 1988 (UK) and now in ch 5 of pt 5 to Income Tax (Trading and Other Income) Act 2005 (UK).

59 Jones v Garnett [2005] EWCA Civ 1553 (Court of Appeal).

Briefly, and in a much simplified form, the story is a familiar one. Mr Jones was an Information Technology (‘IT’) employee made redundant in 1992. He and his wife started an IT consultancy firm. IT agencies would only deal with limited companies so that they and their clients were not bothered with tax and employment law issues, so Mr and Mrs Jones acquired an off-the-shelf company named Arctic Systems and each purchased one of the two issued shares at £1 each. Mr Jones was the company director. Mrs Jones was not a director but was company secretary and handled the administration.

Over four years, Arctic provided Mr Jones’ services to three agencies and four clients, one client at a time. He worked full-time for the company but Mrs Jones spent only four to five hours per week on company business. There was some question of IR 35 applying, but the level of activities was just enough to prevent this. Clearly, in a world without tax and employment law there would have been no need for a company. However, that is not the world we live in and there was a genuine company for perfectly rational and legal reasons. These reasons included tax reasons but fiscal motivation alone does not invalidate a transaction for tax purposes.61 The Joneses knew they were setting up a structure that might result in a tax saving but also, in effect, we can say that Mrs Jones was investing in Mr Jones, just as if the company had owned a painting or a piece of land she would have invested in that.

The turnover of the company was £91,000 and salaries were kept low: Mr Jones was paid only £7,000 pa and Mrs Jones £4,000 pa. This was the area of attack. Mr Jones was clearly being paid less than market value for his work and this allowed profits to be taxed at low company rate and stripped out in the form of dividends with a tax credit and no national insurance to Mr and Mrs Jones who could then both use personal allowances and lower rate tax bands. This was an example of completely standard tax planning.

Although Mr Jones’ salary was on the low side, he and others were very surprised to find themselves under attack for current and past years as a result of HMRC claiming that the settlements provisions applied. The Special Commissioners (at first instance), found in favour of HMRC62 as did Park J in the High Court.63 The Court of Appeal overturned the lower courts and found in favour of the taxpayer. HMRC are currently seeking leave to appeal to the House of Lords. In essence, the issue was whether there was a ‘settlement’. This involved deciding whether there was any element of ‘bounty’, a judicial gloss put on the meaning of settlement and discussed extensively in the case law.64 The statutory definition describes a settlement as an arrangement and much depended on what was included in the arrangement here. The Court of Appeal decided that the arrangement here was the acquisition of a share for which both parties paid full value in the context of a joint business venture to which both would contribute. The governance arrangements under which Mr Jones but not Mrs Jones was a director were also included but this did not necessarily confer a benefit on Mrs Jones. There was no ‘bounty’ in this set up. Subsequent dividend payments were not part of the initial arrangement. The company would not necessarily make any profit. It would not necessarily pay dividends. It was all unpredictable. As Keene LJ commented: ‘It is difficult to regard such a Protean state of affairs as capable of being part of an arrangement in the sense


used in the legislation. Carnwath LJ, with whom Keene LJ agreed, stated that the purpose of the legislation was not clearly ascertainable and in those circumstances the Revenue’s position seemed to be to argue for an unwarranted extension:

For the first time, they seek to apply the concept to what has been found to be a normal commercial transaction between two adults, to which each is making a substantial commercial contribution, albeit not of the same economic value. Such a difference, by itself, is not enough to my mind to take the arrangements into the realm of ‘bounty’, as it has been understood in the existing cases. If the legislature wishes such an arrangement to be brought within a special regime for tax purposes, clearer language is necessary to achieve it.

While it is easy to see the mischief being attacked here, the use of the settlements provisions is widely thought to be misconceived. It is a lazy approach to policy making because the problem is perceived as being too hard to tackle with specific and structural legislation. This has created serious uncertainty for many small businesses and a general sense of persecution. The purpose of referring to the case in this paper is to highlight this policy failure rather than to investigate the fine detail of the settlements provisions, although there is an important story to write on this also.

The central feature creating this problem is the ability of micro-businesses to incorporate and thus transform income from labour into income from capital. Within a family context but where the regime is one of independent taxation of spouses, there are many conflicts of policy and practicalities. This is a question that needs addressing in a holistic way, looking at the rules on family taxation, small business taxation and capital transfers between spouses in the round. Instead, the government has allowed HMRC to continue to address the issue as a self-contained operational matter. They have attacked a form of doing business which has a long pedigree with anti-avoidance legislation designed for another purpose in the 1930s.

It is arguable that Jones v Garnett affects fewer businesses than is being implied by the professional bodies, who claim it could affect 200,000 family businesses. HMRC argue that only 30,000 businesses are at risk and this may be because they may pursue this only in what they consider to be extreme cases (although the case of Mr and Mrs Jones hardly seems extreme). This is not a sufficient safeguard, however. Small company owners cannot know whether they are at risk since, even after the test case is decided, each case will be decided on its facts. They are required to self-assess and are subject to penalties if they get this wrong. The HMRC Guide runs to 50 pages, with detailed examples but cautions that there may be circumstances in which the interpretation it gives will not apply because cases turn on their own facts. In effect, the rule that HMRC really want to apply is that set out in their summary at paragraph 6.2 of the Guide:

When considering whether or not the settlements legislation applies it is worth remembering that Parliament introduced the settlements legislation to prevent individuals transferring their income to a relative or friend in order to avoid tax. It therefore follows that a simple test to indicate whether or not the legislation might apply is to consider whether the same arrangements would have been made with a third party at arms length. Take a step back and consider, “If I was making these arrangements with an independent third party would I be paying them these wages or dividends or sharing my partnership profits in this way? If the answer is no then the legislation probably applies.

This looks very like a GAAR. The UK does not have a GAAR and the Court of Appeal has not applied the above test but, rather, one based on the wording of the settlement provisions which HMRC sought to apply.

66 Ibid [108]. Carnwath LJ. Other detailed issues arising in the case were whether, if there was a settlement, there was an applicable exception for an outright gift which was not substantially a right to income. This could become important in the House of Lords if it is decided there is a settlement but the comments were obiter. The legislation is obscure with a complex legislative history.
67 Figures are taken from the High Court hearing: see Loutzenhiser, above n 60.
68 HMRC Guide, above n 60.
On the facts of Jones v Garnett, the settlements provisions did not have the effect HMRC are arguing for. But small business owners have little guidance on which to base their self-assessment tax returns due at the end of January 2007, although the professional bodies have done what they can to assist69 The result is complexity and uncertainty and a sense that the Government is antagonistic to small business which is precisely the contrary of what government policy set out to be.

It is interesting to note how similar a position seems to have been reached in Australia by the very different route of the GAAR. The ATO comments that in its Taxfacts note that:

> others may disagree with these views and that concepts of employment, business and entrepreneurship have progressed since the cases from which our views were formed were heard. We are looking to identify test cases to obtain further judicial guidance as to the correctness of our views. We are doing so in consultation with tax professional bodies.70

Although the Commissioner has lost the case of Ryan, the ATO continues to argue that Part IVA of the ITAA36 may apply in blatant cases, but perhaps not in standard husband and wife partnership cases. In a case where the remuneration of the main service provider was very low, as in Jones v Garnett, it is not clear what the ATO views would be.

In neither jurisdiction does this seem to be a good way to create or implement policy for small family businesses. It fails to understand the nature of such businesses and the contribution made by them as well as the importance of tax stability. In the UK, the approach of the government requires the courts to answer impossible questions about the value of a spouse’s contribution to the business because the tax system has permitted income from employment to be converted into income from capital. If a person in Mr Jones’ position is to be taxed on a minimum deemed salary then this needs to be made clear and the circumstances in which it is to happen must be spelt out. In trying to formulate these circumstances, policy makers would encounter grave difficulties as there is a lack of clarity of objective. They should not expect the courts to be able to solve this problem for them. The current approach falls predictably and firmly into the pitfalls for those making small business policy.

**IV THE MORAL OF THE STORY AND LIVING HAPPILY EVER AFTER**

As with all cautionary tales, it is easier to deliver dire warnings than to prescribe a course of action, other than staying at home and avoiding all excitement. Perhaps that is the lesson here for governments. The best thing may still be to interfere as little as possible, to keep change limited and to move away from introducing a lot of special schemes which require definition, thresholds and anti-avoidance provisions. Keeping it simple may mean just that: doing nothing.

The tax system for small businesses will only be as good as the system for business generally and, given the drawbacks with profits taxes and the problems of integrating corporate level and shareholder taxes we cannot expect an easy answer for small businesses. The ideal might seem to be to alignment of treatment of all businesses, whatever their legal form, to prevent opportunities for arbitrage, but given the very real differences between businesses at each end of the spectrum this looks less attractive and even less possible when

69 Guidance note from professional bodies, above n 60. The case is due to be heard by the House of Lords in mid-2007. HMRC have not altered their Guide in the meantime. They say in Jones v Garnett: Further Advice ‘We have been granted leave to appeal to the House of Lords, and the Court of Appeal decision cannot therefore be regarded as final. In the circumstances we believe it would be premature to reconsider the guidance and the examples we issued in November 2004 … The correct time to do that is when the case has been finally resolved. http://www.hmrc.gov.uk/trusts/jonesvgarnett-further-advice.htm

70 ATO, above n 57.
examined in detail.\textsuperscript{71} The latest major report on tax reform, the US President’s Advisory Panel report,\textsuperscript{72} offers a radical proposal for all firms, the Growth and Investment Tax Plan, which is a quasi-consumption tax, or a less radical Simplified Income Tax Plan. The latter would offer cash basis accounting for business under $1 million annual cash receipts. Small businesses could expense all outlays and would have no other special measures, for example no research and development credit. SMEs, incorporated or not, would use designated bank accounts for all business income and expenditure. The report is a little short on practical detail but it seems that the bank would report direct to the Internal Revenue Service and business would be prohibited from making personal expenditures out of this account. Small firms would be taxed on a pass-through basis regardless of legal form, as most are now in the US, but would also have a choice to be taxed as corporations at a lower rate. It has been suggested that the proposals offer significant potential for tax sheltering.\textsuperscript{73} Unfortunately, the proposals seem to understand small business very little and the significance of legal form in terms of real legal consequences even less.\textsuperscript{74}

There may be administrative changes that can be made to ease the lot of small business in connection with their tax burden but for the most part they want clarity and stability rather than the ‘attractive complexity’ of a great selection of schemes on which advisers may like to advise them but about which they would sooner not have to worry even if the result is a little more tax. The time of the business owner may be worth more than the tax saving resulting from such schemes. If certain behaviour is seen as undesirable, then revenue authorities need to spell out the circumstances clearly, for small business owners will take advice from tax advisers on tax minimisation quite reasonably and should not have to make fine distinctions dependent on case law to ascertain whether what they are doing will be effective. Governments must remember that small business ownerS, even if very close to being disguised employees, are legally not employees and do not have their advantages. The small business owner may well see him- or herself as running a small business, encouraged by the rhetoric of governments themselves; if he or she takes risks that the clients will not bear, why is she or he not performing one of the functions of a genuine small business and why should he or she not be able to take the tax advantages the system offers such risk takers?

The message to tax policy makers, therefore, is to examine small businesses, especially micro-businesses in their social and family context. Understand what drives them and that they are not simple. Small business owners have many motivations and targeting tax relief to a whole range of businesses in this way will affect behaviour across the range and not only to enhance entrepreneurship and growth. Do not confuse cause and effect: incorporated businesses may be more likely than unincorporated ones to grow but it does not follow that all incorporated firms wish to grow, especially if there are tax advantages to incorporation without growing. At the same time, recognise that legal form really does make a difference to rights and obligations and therefore to economic substance so that encouraging incorporation should not be done lightly. It is not a popular message but perhaps incorporation should be made harder and not easier. The easy availability of such a form for the small business is not a simplification and perhaps is an attractive complexity.

Finally, in attacking a perceived mischief, policy makers must be clear about the mischief and its underlying causes. If the cause is a distortion in the tax system, do not blame the small

\textsuperscript{71} This will be examined in more detail in the small business chapter of the Mirrlees Review (forthcoming, <http://www.ifs.org.uk/mirrleesreview>) and see Judith Freedman, ‘Small Business Taxation – the indefinable in pursuit of the unachievable?’ Hardman Lecture, 2006 (Tax Faculty of the Institute of Chartered Accountants in England and Wales, <http://www.icaew.co.uk/index.cfm?route=105098>).

\textsuperscript{72} The US President’s Advisory Panel, above n 25, chapter 6.


\textsuperscript{74} Daniel Shaviro, ‘Blueprint for Future Tax Reform?’ (2005) 109 Tax Notes 827 questions the practicalities.
business for utilising the distortion. Micro-business owners are not always rational but neither are they entirely irrational. To return to the cautionary tale, if business owners are offered sweets, they will take them, but if they find they are laced with poison they may learn eventually not to take any more sweets.

Sweets need to be handed out with care, to the people who will benefit from them, and they should not contain poison.