The Road from Serfdom

Guide to the Policy

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1. SUMMARY OF THE POLICY

1. Corporation Tax abolished for small companies.

2. Capital Gains Tax abolished for investors in small companies

NOTE

a) *The average UK company has 5 employees.*

b) *90% of all UK companies are small companies (small companies are those with fewer than 50 employees).*

c) *These companies account for half all UK private sector employment.*

d) *Of those without jobs in 2010, and who have since found private sector jobs, 73% have done so in start-ups or small businesses.*

e) *Of those without jobs in 2010 and who have since found private sector jobs, only 8% have done so in large businesses (19% have done so in medium-sized businesses).*

2. IMPACT OF THE POLICY

The Policy outlined in this document will:

- abolish Corporation Tax for 90% of UK companies
- reduce the deficit faster than predicted by the OBR
- expand employment faster than predicted by the OBR
- increase competition and challenge Cartel Capitalism
- let millions of people grow tall.

These millions of individuals will enjoy:

- the opportunity to say “I am the captain of my ship”
- more money
- more freedom
- the first step on The Road from Serfdom.

The nation as a whole will benefit from:

- a change in culture as big as “Own your own Home” in the 1980s
- greater economic growth and lower unemployment than forecast by the OBR
- more competitive market places
- more freedom and independence from Big Government and Big Companies.

3. FISCAL OUTCOMES OF THE POLICY

The following fiscal and employment outcomes of the Policy are calculated using detailed modelling based on OBR data. A full explanation and details of the assumptions underlying the model can be found in Section 8 and Appendix 2. The model itself, along with a number of technical papers, can be found at www.cps.org.uk/thepolicy. In all cases, the assumptions have been made on a cautious basis.

The Policy has an initial static cost of around £10.5 billion net, comprising of:

- £8 billion lower Corporation Tax receipts
- £3.5 billion reduction in Capital Gains Tax receipts
- compensating revenue gains of abolished income tax relief on EIS/VCTs of £0.5 billion and extra income tax on dividends of £0.5 billion.

However, the results from the Model show that:

- these costs are recouped relatively quickly
- the net impact on the Exchequer is positive within the life of a single Parliament
- the positive impact on the deficit (and eventually the National Debt) is significant from Year 4 onwards.

How is this achieved?
Follow the money!

What happens to the £11 billion? Where does it go?

Clearly, it does not vanish. So the questions are: who has it? And what do they do with it?

As small companies will no longer pay Corporation Tax, those that are profitable will see their profits increase. It is then assumed that these increased profits will be used in the same way that small companies used their profits between 2009 and 2013 (a period both long enough to derive meaningful estimates and sufficiently close to the forecast period for the estimates to remain valid – see Section 8 for more details). On this basis, approximately:

- 17% will be paid out as windfall dividends to owner-managers
- 31% will be paid out as additional compensation to employees
- 51% will be paid out as extra investment

The model then calculates how this money is recycled into the economy. By Year 4, on the most cautious assumptions, the Treasury receives:

- extra income tax on the dividends paid to owner-managers
- extra income tax and NIC receipts from the additional compensation paid to employees
- extra VAT receipts from the additional spending made by owner-managers and employees out of their higher earnings
- extra tax receipts generated by higher GDP, such as more corporation tax on the increased profits of large companies
- lower welfare costs as more people move into work

The tax abolition triggers a snowballing effect. As more people find work, and are able to spend more in the shops, and as small companies invest more, the economy enjoys much higher growth. By Year Four the Policy is raising more in tax for the Exchequer than the OBR forecast would occur without the tax abolition, creating a larger budget surplus.

The following tables summarise the forecast outcomes and compare the current OBR forecasts (as published in the 2014 Budget) with the Policy. This assumes that the tax saving for small companies is reallocated between dividends, employee compensation and investment, and the consequences for GDP worked through,. Note that the model makes no assumptions for any cultural effects such as an increase in entrepreneurialism and/or "animal spirits".

Some analysis of these forecasts can be found in Section 8.

GDP Growth (at constant market prices)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	+2.4%	+2.6%	+2.6%	+2.4%
Outcome of the Policy	+2.4%	+3.2%	+3.5%	+3.1%

The Deficit (Public Sector Net Borrowing, £ billions)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	68.3	41.6	17.7	-1.1
Outcome of the Policy	68.8	44.1	21.8	-2.8

The National Debt (Public Sector Net Debt, £ billions)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	1439	1497	1530	1548
Outcome of the Policy	1439	1499	1534	1546

Debt/GDP ratio (at market prices)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	78.7%	78.3%	76.5%	74.2%
Outcome of the Policy	78.6%	77.6%	75.3%	72.3%

Government Revenues (Total Current Receipts, £ billions)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	675.4	711.0	743.4	777.7
Outcome of the Policy	674.8	707.8	738.2	778.1

New Jobs created (to nearest 10,000)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	250,000	250,000	260,000	270,000
Outcome of the Policy	310,000	690,000	900,000	920,000

4. THE ACE OF TRUMPS

The Leader of the Labour Party looks forward to startling the House of Commons, as Sir William Harcourt did 100 years ago, by announcing:

> *We are all Socialists now*

Many Conservatives rejoice at this news, that Labour is again about to sign 'the longest suicide note in history'. Is that true?

It has been 22 years since the Conservative Party won an Election – a generation. You hear it said that the Party was unlucky to have a succession of five leaders with insufficient appeal to voters. That seems statistically unlikely. A more plausible explanation is that the Party has sometimes underestimated the appeal of Socialism.

Isaiah Berlin described Socialism as:

> *The greatest organised social movement of all time, greater perhaps than the rise of Christianity against Paganism*

But we went off Socialism because it didn't produce any money. The central Thatcher/Reagan critique of Marxist Socialism was always that it didn't create wealth for its citizens.

So then we liked Capitalism. But now we have gone off that too because it seems to produce too much worship of the Golden Calf.

So now we don't know what we like.

That is probably why, on so many key political issues, when the public is asked:

> *Which party has the best policies on...*

the answer is often:

Neither

The fatal flaw of Capitalism is said to be greed. But 'greed' is part of the system – more politely known as rational self-interest. The central mechanism by which it is said to work is competition, best described by Professor Lionel Robbins at LSE:

> *Every day thousands of people cast their votes for the hundreds of products and services on offer, and from the competition to win their votes better and better products and services arise*

That is said to be how the Capitalist system brings the best outcome for all. But that does not seem to be how things have worked out in recent years. On the contrary, there has been a dramatic widening of inequality between rich and poor.

Some blame the 'lone gunman' – the rogue trader or selfish banker who wreaks havoc in the whole system. This Bad Apple theory is popular with Conservatives because it is easier to blame one rotten apple than the whole barrel.

Another possibility, much less attractive, is that after all Marx was right:

> *The end result of competition is the end of competition After years of internecine warfare among Capitalists, there would be fewer and fewer Capitalists controlling vaster and vaster empires*

Look at the banks, the trains, electricity, gas, water, oil, or many other large global industries and that prediction seems to have been accurate.

In other words, the unintended consequence of globalisation is cartelisation – the creation of global cartels in which there is a huge imbalance of power between the individual customer and the giant corporation; a sense of powerlessness and unfairness that results from a world of global corporations whose governance (and maybe taxes) are beyond the reach of national governments.

The overwhelming power of money in such a climate is a dangerous moment for Conservatism. What perhaps scares people most is that soon money will talk in health as well as everything else. As a New York investment banker explained:

> *Money means a better car, a bigger house and, in time, a longer life*

People may conclude they need someone to protect them from that kind of 'free market', such as, perhaps, the State. This is why Labour thinks it has struck gold with a State price freeze on energy.

Right now, Conservatives like to say State Socialism is a return to 1970s failure. But will that do? Perhaps not. Because one thing has changed radically since the 1970s, which is that the emerging economic superpower of the world is itself a Socialist State. China calls its own system:

> *State Capitalism, or Capitalism with Chinese Characteristics*

The particular characteristic they have in mind is that the State owns 100% of all large companies. According to the text books, this is a road to ruin, but the bosses of these Chinese companies (mostly good Harvard or Princeton men), have been taught the central role of competition, and are encouraged to compete with each other vigorously, just like American bosses. If they hit their profit targets, they stay. If they don't, they get fired. Sounds familiar, doesn't it?

According to research by the Russian Government, the Russian people can't tell the difference whether the State owns 100%, 60%, 40%, 10% or 0% of a company. In Britain, studies show that many people today are not sure what's worse – Big Companies or Big Government.

It may be illogical to ignore the challenge of this new world order; to stubbornly insist that the existing version of free market Capitalism is the only way forward. That would open the door for Labour to access millions of people, especially young people, who dislike the status quo and want change.

Ed Miliband says:

> *The rising tide lifted only the yachts*

But Conservatives hold the ace of trumps to beat both the milk and water Socialism of the Labour party, and the more robust Chinese version. They know that whatever kind of boat you have, the most important thing is that an individual can say:

> *I am the captain of my ship*

5. PROBLEM: SERFDOM

After two centuries of fighting Big Government, unexpectedly, no sooner was man free than:

Thine enemy shall rise up from thine own house

EXHIBIT 1: Cartelisation

Category	**Top 5 companies market share**[1]
Search Engines	99%
Smartphone Operating Systems	99%
Video Game Software	91%
Radio	90%
Fixed-line telephony	92%
Airline industry	89%
Banking	85%
Cinema screens	80%
Gas	76%
Supermarkets	70%
Electricity	65%

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1 See Appendix 8 for source details.

EXHIBIT 2: Public Opinion

***Do you trust…?*[2]**

	Big Companies	Big Government
NO	69%	71%
YES	21%	20%
DON'T KNOW	10%	9%

A Populus poll of 4,111 voters for the *Financial Times* (6 May 2014) also revealed "dismal levels of public trust" in big companies: 61% of British voters want the party that wins the next election to be tougher on "big business".[4]

I once asked Mrs Thatcher whether she knew the share of the top five banks in all UK financial transactions – mortgages, bank accounts, savings accounts and so on.

She said she didn't know.

I said "80%".

She said, eyes blazing: "That is impossible."

By impossible she did not mean not true. She meant intolerable.

As T.S. Eliot might have said, on behalf of Mrs Thatcher:

> *That is not what I meant at all;*
> *That is not it, at all.*

China changed the nature of State Socialism.

So now it's our turn.

To change the nature of Market Capitalism.

Perhaps Conservatism can help.

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2 Polling conducted by ComRes who interviewed 2,060 British adults online between 23 and 26 May 2014. Data were weighted to be representative of all GB adults aged 18+.

4 "Most voters – and half of Tories – want clampdown on big business", *Financial Times*, 6 May 2014.

6. SOLUTION: FREEDOM

This Policy has the capacity to provide and express ideals which are at the heart of Western civilisation. Conservatives do have an ideology. But they have either lost sight of it, or don't know how to express it.

At its core, is the belief that man is responsible for his fate; that mankind has a need to be responsible and master of his own destiny. And that men and women have the power, given the right social circumstances, to be masters of their social world, to take control of the social structures in which they exist.

Ironically, Karl Marx described as well as any Conservative the Conservative ideal of self-realisation: the development of human potential in many different facets and directions for each person, so that a man could be:

> *…a hunter in the morning, a fisherman in the afternoon, a cattle rearer in the evening, and a critic after dinner.*

In this, Conservatism follows Nietzsche's most consistent words of advice, his 'Ethical Imperative':

> *Become who you are!*

As in Zarathustra:

> *If you would go high, use your own legs.*

So while we can admire such well-known Conservative characteristics as the love of the concrete in preference to the abstract, and intolerance of mere book-learning, it is an error to think of Conservatism as merely a belief in 'practicality' and 'efficiency'. True Conservatism is practical idealism. Its aims, instead of being merely materialistic and mechanical, are idealistic to the point of being Utopian.

Despite Conservative protestations of ideological innocence, all Conservatives do have one deep belief – in a free and independent individual. It is there in the

beating heart of every Conservative. Like gravity, you don't have to invent it. You only have to discover it. And this Policy expresses it. The driving motive of Conservatism is a belief in independence, individuality, self-determination.

Independence

This Policy meets the claim of men, as Aristotle put it:

> *...to be ruled by none, if possible.*

Or, if this is impossible, to be as independent as they can reasonably be.

Individuality

As the aim of this Policy is the full self-development of each individual, it follows that it aims to ensure that each person has the resources to achieve this.

This means that Conservative belief in freedom is inextricably connected to economics. Because, in the real world, personal independence (of the kind admired by all Conservatives) and economic independence are inextricably linked.

This is why economics is such a crucial issue for Conservatives – not because, as critics say, Conservatism is 'money-obsessed', but because, as Iain Macleod said:

> *Money is the route of all progress*

Money and freedom are connected. To deny that is to row the Conservative boat with one oar. After all, as Professor J.K Galbraith remarked:

> *The greatest restriction on the liberty of the citizen is a complete absence of money*

Self-determination

Conservatism believes that:

> *Caring that works costs cash*

The Good Samaritan showed that first you need the money in order to do the good works.

Conservatism says that lower tax is good – for moral reasons, because it means more freedom and choice for individuals: and for economic reasons, because ironically lower tax rates can mean higher tax revenues and more wealth creation.

Conservatism says that even the meekest can meet life with the possibility of mastering its difficulties.

This guiding thread of Conservatism was well expressed in a remarkable essay in 1784:

> *An Answer to the Question: What is Enlightenment?*

In it, Immanuel Kant declared that to be civilised is to be grown-up. To be grown-up, he went on, is not to abdicate one's responsibilities to others, not to permit oneself to be treated as a child, or to barter away one's freedom for the sake of security and comfort. He said a paternalist government, based on:

> *The benevolence of a ruler who treats his subjects as dependent children… is the greatest conceivable despotism and destroys all freedom.*

Unless a creature can determine itself, he said, it is not a moral being. Kant was definite on this point – independence is the basis of all morality.

The record seems to show that Thatcher out-thought Marx. Marx said:

> *Philosophers have only interpreted the world. The point however is to change it*

But Thatcher explained how to change it:

> *If you want a bigger slice of cake, the best thing to do is bake a bigger cake, then everyone gets a bigger slice*

To bake a bigger cake, the tax system is the great underutilised weapon of our time. Long ago fallen from the grand role of 'social engineering', it has been reduced to the junior role of 'revenue generation'.

Yet, it is on a par at least, with the NHS or the criminal justice system, in its impact on human lives, and its connection between government and the people. This Policy shows how the awesome power of taxation can be used to the benefit of everyone.

The importance of ideology

All proponents of 'the centre ground' in politics take satisfaction from analogy with the game of chess.

Wilhelm Steinitz, the first official world chess champion, on whose scientific principles chess is now based, said it was always good, on principle, to take an opponent's central pawn.

In the geometry of the chessboard, control of the centre – the four central squares and the eight squares round them – takes precedence; control of the centre is needed to maintain communication between the two wings, enabling a player to bring unrivalled power to bear over the whole board.

The chess analogy proved attractive to pragmatic politicians on both sides of the Atlantic, who decided, as a matter of electoral calculation, that they were better off in the centre.

President Clinton made the opening gambit – a Left to Right move praising profit, tax breaks, the market economy. Tony Blair copied the move. New Labour attempted to combine compassion with competition, freedom with fairness and so on. Between them, they won five elections in a row – a tribute, all agreed, to the power of 'the centre ground'.

Fuelled by their electoral success, reinforced by the rise of globalisation (if barriers between countries could come down, why not between political parties?); symbolised by the fall of the Berlin Wall (so that there were no dragons left to slay); and endorsed by academic works like *The End of History* and *Beyond Left and Right*, the 'centre ground' was born and became the conspicuous political feature of the age – the equivalent of a political law of gravity.

It grew and grew until it achieved the level of dinner party platitude in London and New York – as in the popular injunction:

> *You can only win elections from the centre ground*

Even the Conservative Party succumbed. Hurt by long years of condemnation for ice-cold brutishness, it attempted to shed its 'nasty' image with a simple move from Right to Left.

In a rare lecture on politics, T S Eliot warned of the danger of that approach. He defined a political party as:

> *…a movement, guided by permanent principles, a body of doctrine, disseminated and popularised through emotional appeal*

He contrasted that with pragmatism – a series of metamorphoses and adaptations to issues as they arise, the effect of which, he said, can be:

> *So endlessly and obligingly adaptable to changing circumstances that it discredits itself by its indifference to principle*

Eliot was right. That is how the pragmatism of the centre ground turns politics into a commodity market – because pragmatism leads to opportunism, which leads to cynicism.

Without ideology, political discourse is reduced to claim and counter claim about actual 'delivery'. But in that arena, today, as we saw earlier, there is only one winner:

> *Neither*

The consequence can be seen in British politics.

Applied to politics today, the great Hollywood law:

> *Nobody knows anything*

Should read:

> *Nobody believes anything*

One direct result of this convergence on the centre ground is a super-cynical British electorate and low turnouts at election time.

The slowest to turn out, young people, are often criticised for moronic addiction to computer games and social media. But theirs might be the most rational response to centre ground politics. As one student said during the last election:

> *They just tell you what you want to hear. There's no actual ideology*

This absence of a moral vision, the inability to articulate a motive, is reflected in this test.

Which of these descriptions best our society? This…

Article of faith, conviction, moral certainty, unshaken confidence, take as gospel truth, take on trust, pin one's faith on, take at face value, take one's word for, buy into, be certain, have no doubt, have no second thoughts, no reservations

Or this…

Hard to believe, lack of conviction, under suspicion, credibility gap, hard to swallow, without faith, nobody's fool, not born yesterday

Those are the Thesaurus entries for 'Belief' and 'Unbelief'…

In Britain, the centre ground has ground the ideology out of politics.

But the Court of Public Opinion is like the Court of Law – the jury seeks motive and intent as a sign of character.

The motive of the Policy is freedom. Its intent is independence.

7. METHOD: MONEY

7.1 Abolition of Corporation Tax for small trading companies

7.1.1 The Policy

Corporation Tax will be abolished for all small trading companies with effect from their first accounting period beginning on or after 1 April 2015.[5]

7.1.2 The Context

According to the latest available BIS estimates,[6] at the start of 2013, there were 4.9 million UK private sector businesses (i.e. both companies and also those which were unincorporated), employing 24.3 million people and with a combined annual turnover of £3,300 billion. Almost all of these businesses (99.2%) were small, in the sense that they involved sole proprietors, partners or had up to 49 employees. Between them these small businesses accounted for 47.0% of private sector employment and 33.1% of private sector turnover.

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5 The definition of "small company" is taken from the Companies Act 2006. An individual company qualifies if it has at least two of the following three characteristics:

- Turnover of not more than £6.5 million
- Gross assets of not more than £3.26 million
- Not more than 50 employees.

Companies operating in the oil and insurance sectors would be excluded, because they already have their own bespoke tax regimes. Full definitions of a "small company" and a "trading company" can be found in Appendix 3.

6 Business Population Estimates for the UK and Regions 2013 (released 23 October 2013). Despite its name, the statistics it contains relate principally to the 2012 calendar year. Note that BIS publishes business statistics using a definition of "small" which is different from those published by its executive agency, Companies House, so that neither set of figures matches up exactly. In addition, the tax system has a third definition of "small company" which is completely different to both.

The corollary of this is that only 0.8% of all UK businesses are Big, or merely Medium-sized. However, between them they are responsible for 53% of private sector employment and generate 67% of all private sector turnover.

According to the latest available Companies House statistics,[7] as at 31 March 2013 there were a total of 2.2 million registered companies in the UK. Ignoring those which are dormant, the Companies House data reveals that 91.6% of the active companies in the UK would be eligible for the tax exemption because they would qualify as "small companies" under the definition chosen here. Potentially, if other small but unincorporated businesses decided to convert to company status, the Policy would exempt the full 99% of UK enterprises which are not Big Businesses.

By allowing profitable small companies to retain more of their earnings it will become easier for them to self-finance their own expansion. This dynamic sector of the economy would become less reliant upon credit granted by the banks. This competition should in turn encourage the banks to be more supportive of commercial customers generally, in order to maintain their own positions against a possible loss of custom.

A higher level of investment sustained over the long term should also help improve medium-term productivity.

7.1.3 Cost implications

Total Corporation Tax receipts in 2011/12 were £43.8 billion.[8]

The latest available HMRC statistics,[9] for the tax year 2011/12, showed that there were 980,266 companies with a liability to corporation tax. Of these, 894,882 or 91.3% were charged at the "small profits rate" (i.e. the companies had taxable profits of up to £300,000). Together these low-profit companies contributed around 18% of the total corporation tax receipts – or about £8 billion.

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7 Statistical Tables on Companies Registration Activities 2012/13 (released 23 July 2013).

8 Total combined corporation tax receipts for 2011/12 were £43.8 billion, but this includes £8.4 billion of "offshore" corporation tax paid by companies operating in the North Sea under a separate tax regime (which would not be affected by the Policy – see Appendix 3). "Onshore" receipts, which would include the tax paid by most UK small companies, totalled £35.4 billion.

9 Corporation Tax Statistics (released 31 October 2013).

There are definitional differences between a “small company” for the purposes of the Policy and a company paying tax at the “small profits rate” under the current tax system, but our research indicates that £8 billion is a reasonable estimate of the annual static cost. This would be increased by the loss of Self Assessment income tax paid by traders who converted their businesses to companies. The absolute ceiling on that cost is around £7.5 billion, but the impact would be phased over time and the full cost would not be recognised in the forecast period covered by the Model.

The Model discussed in Section 8 indicates that all these costs would be recovered over the life of a single parliament. The tax saving by small companies is used to pay for additional employee compensation (which creates extra PAYE and NIC revenues), additional dividends for owner-managers (which creates extra Self Assessment income tax revenue), additional private consumption spending (which creates extra VAT revenue) and additional private investment. The increased GDP which results from this generates extra revenue from companies which have not been exempted from corporation tax and from other taxes and duties.

7.2 Abolition of CGT on shares in small trading companies

7.2.1 The Policy

From 6 April 2015 Capital Gains Tax (CGT) will be abolished for individuals when they dispose of shares in companies which qualified as small trading companies when the shares were acquired. Transitional rules would determine which shares acquired prior to this date did not qualify for the exemption. There would be no change to the headline rates of CGT for other assets.

Well-intentioned but complex and largely ineffective schemes – such as the Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trusts (VCTs) – would become redundant and be abolished.

There would be no requirement for the shareholder to be an employee or officer of the company. There would be no minimum shareholding for exemption to apply. There would be no minimum holding period for ownership of the shares.

Losses on investments in small trading companies could still be used to offset other chargeable gains. There would be no change to the current tax system on this point.

CGT exemption would be driven solely by the status of the shares when they were acquired. In general the size of the company at the time of disposal would be irrelevant.[10]

7.2.2 The Context

The existing EIS, SEIS and VCT schemes are supposed to encourage investment in small trading companies by offering tax breaks: income tax relief on the amount invested; and exemption from CGT on an eventual sale of the shares. Complicated restrictions apply on which trading activities qualify, the amounts which people can invest and their connection to the company, and the minimum period which shares must be held before sale.

According to the latest available HMRC statistics,[11] for the tax year 2011/12, the cost to the Exchequer of EIS was £230 million and the cost of VCTs was £130 million.

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[10] See Appendix 4 for further details.

[11] HMRC Estimated Costs of the Principal Tax Expenditures and Structural Reliefs (December 2012)

However, when these figures are matched with other HMRC statistics for the amounts invested in EIS[12] and VCTs[13] for 2011/12, it can be seen that almost all of the cost represents income tax relief on the acquisition of shares, not exemption from CGT on a sale. Investors as a whole have not been realising significant gains. No equivalent figures are yet available for SEIS, which was only launched in 2012, but there is no reason to suppose the position would be any different.

These schemes may be abolished safely without anticipating any adverse effect on small companies' access to capital. Under the Policy investors would be able to acquire CGT-exempt shares without the current complicated restrictions in a wider range of businesses. Investors would not be receiving upfront income tax relief, but the companies whose shares they acquire would not be paying corporation tax, so could be expected to appreciate tax-free gains more rapidly.

Entrepreneur's Relief is the principal CGT exemption for owner-managers. It allows gains on the sale of shares in trading companies to be taxed at a flat rate of 10% (instead of 18% or 28%). But this only applies to owner-managers who hold at least 5% of the company's shares, which will exclude most employee-shareholders, and the gains which can enjoy the favourable rate are subject to a lifetime limit for each investor, which discourages successful entrepreneurs who want to reinvest their gains in a new business. Investors are clearly better off, and hence more likely to invest in small companies, under a system which carries a tax rate of 0%, and there are no restrictions on the minimum qualifying shareholding or whether they are employed by the business.

7.2.3 Cost implications

Total CGT receipts in 2011/12 were £4.3 billion.[14]

This amount should be adjusted for the impact of EIS, VCTs and Entrepreneurs' Relief. Had those schemes not been in place, the gross CGT revenue for 2011/12 would have been around £6 billion. It is worth noting that the OBR forecasts a significant increase in CGT receipts in the near future, to £9 billion p.a. An equivalent figure adjusted for the abolition of EIS, SEIS, VCTs and Entrepreneurs' Relief would be about £12 billion.

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12 HMRC Enterprise Investment Scheme Statistics, release 13 December 2013

13 HMRC Venture Capital Trust (CGT) Statistics, release 19 September 2013

14 Budget 2013, Table B.3 (Current Receipts)

Even though the OBR anticipate a significant increase in CGT revenue, their latest estimates represent a reduction in the amounts they were forecasting at the time of the Autumn Statement in December 2012. This is because the January 2014 receipts, in respect of tax year 2012/13, were 22% below expectations, and this shortfall has knock-on consequences for the estimated revenue in future years. The OBR concede that CGT is one of the most difficult to taxes to predict. For these reasons our Model does not incorporate any gains from the savings which investors would make under the Policy.

According to HMRC statistics,[15] approximately half of all gains subject to CGT represent the sale of shares in companies which are not listed on a stock exchange, and which could potentially benefit from the Policy. Some of those companies, although unlisted, would nevertheless be too large to qualify. Adjusting for this, and also taking into account the fact that the OBR forecast a significant increase in CGT receipts under the existing tax rules, it would be reasonable to assume that the Policy would have an initial cost of £3.5 billion, rising to a maximum annual cost in the region of £4 billion as against the OBR forecasts.

There would be compensating gains, however, from the abolition of the income tax relief attached to EIS, SEIS and VCTs. Taking into account the OBR forecast of rising capital gains activity, this extra income tax revenue is estimated to be in the region of £0.5 billion p.a.

The Model discussed in Section 8 indicates that, taken together with the other effects of the Policy, the net cost of CGT exemption would be recovered in the lifetime of a single parliament.

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15 HMRC Capital Gains Tax (CGT) Statistics, releases 29 November 2011, 30 November 2012 and 31 October 2013

7.3 Reform of UK dividend taxation

7.3.1 The Policy

With effect from 6 April 2015, dividend income received by UK individuals from UK companies would be treated as part of general income and taxed as such. It would cease to be a special category subject to its own special income tax rates. The tax credit on franked dividends would be increased, to reflect the actual rate of corporation tax (which will be 20% from 2015/16), and there would be no credit on unfranked dividends.

7.3.2 The Context

Companies are merely a legal device by which individuals organise the exploitation of resources. Corporation tax on profits cannot be treated in isolation from the income tax treatment of the dividends paid by companies. A change in one part of the equation ought to lead to a change in the other.

The Policy aims to remove a potential anomaly. If shareholders in small companies were receiving dividends on which they could claim a credit equivalent to tax at 10%, but in fact the underlying profits had suffered no corporation tax at all, then they would receive a windfall benefit. In contrast, shareholders in medium/large companies would be paying income tax at the same rates on their dividends, but those dividends will have already suffered corporation tax at 20%.

Given that investors in small companies would be exempt from CGT on a capital return when they sell, it would be unfair to also allow them an inflated income return in this way. Thus, the Policy establishes a level playing field as between investors in different types of company by removing the tax credit on small company dividends. At the same time the opportunity is taken to simplify the tax system by removing some of the complexity introduced by Gordon Brown. The net effect is that nobody is left with after-tax dividends which are larger, or smaller, than they would be under the present tax system.[16]

[16] See Appendix 5 for a detailed discussion of this Policy and its implications.

7.3.3 Cost implications

The initial intention was that this change would represent a cost-neutral reform, based on fairness.

In actual fact, the Model discussed in Section 8 indicates that this aspect of the Policy would be revenue-positive for the Exchequer. To the extent that small companies pay higher dividends to their owner-managers, a proportion of the corporation tax abolition would be recouped. This would be equivalent to around £0.5 to £1 billion per year.

8. IS THIS AFFORDABLE?

Some will believe that abolishing corporation tax for small companies and liberating their investors from CGT is right in principle. But they may also feel – particularly at a time when the deficit is so large – that it would be too expensive for the Exchequer.

To gauge the cost of the Policy, a Financial Model (the "Model") has been constructed to estimate the impact of the Policy should it be implemented in full in the 2015 Budget.[17] For each tax year between 2015/16 to 2018/19, the Model estimates:

- The annual growth rate of the economy
- The government budget deficit (Public Sector Net Borrowing)
- The burden of the National Debt (the amount of Public Sector Net Debt and the ratio of that debt to GDP)
- Total tax receipts for the Exchequer
- The number of new jobs created

The forecast period for the Model is limited to four years because 2018/19 is the last year for which the OBR have produced their own forecasts. The Model uses only official statistics and forecasts. It does not make its own predictions as to the underlying performance of the UK economy.

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[17] The full model can be viewed at www.cps.org.uk/roadfromserfdom

8.1 Methodology

Using the OBR forecasts, the tax saving from the Policy which small companies would receive is identified. This amount is then allocated as follows:[18]

- 17.4% paid out as windfall dividends to owner-managers
- 31.2% paid out as additional compensation to employees
- 51.4% paid out as extra investment

The Model assumes that there is a time lag between each of these payments (of one financial quarter for dividends, two financial quarters for wages and three quarters for investment). In other words, companies hold the tax saving as part of their cash reserves and only spend it gradually. Thus, a tax saving on earnings generated in, say, 2016 Q2 would not be fully spent until 2017 Q1. Businesses are not expected to suddenly embark on an immediate spending spree. Indeed, the Model forecasts that entrepreneurs would increase their own returns first.

Because small companies would now be exempt from tax on their profits, there would be an incentive for unincorporated traders and partnerships to turn themselves into companies in order to exploit the new tax system. That was the reaction which occurred over the period 2000/1 to 2005/6 when Gordon Brown experimented with low or zero starting rates of corporation tax.

Using HM Treasury data from that time, the Model estimates how much business would convert. The Model assumes that the level of conversion would be much higher than observed during 2000/1 to 2005/6 and that the process would gather momentum over time. That accords with common sense expectation. The Model assumes that eventually there would be a more or less total conversion of the self-employed to companies. That almost certainly exaggerates what would happen in practice, but it does mean that the Policy has to “work harder” in order to out-perform the OBR Base Case.

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[18] These proportions are based on official data on how companies used their profits between 2009 and 2013. This reference period has been chosen because it is both sufficiently long enough to derive meaningful estimates and sufficiently close to the forecast period for the estimates to remain valid. This interval covers a time during which the UK economy was performing poorly (so is not based on over-optimistic assumptions about the rate of recovery). It is also a period during which HM Treasury was cutting the headline rates of corporation tax (so it provides a reasonable illustration of how companies react during a period of tax cuts).

The Model calculates the effects on consumer spending (for both the increased dividends and increased employee compensation) and the level of each component element of GDP forecast by the OBR is then recalculated.

Government spending is assumed to remain exactly as forecast by the OBR apart from the cost of Job Seeker's Allowance (which is adjusted for the new employment levels) and debt interest payments (which is adjusted to reflect the new difference between total expenditure and current receipts).

The new employment level is derived by assuming that each new worker is hired at the "average wage" for each quarter forecast by the OBR, i.e. the fall in unemployment is not artificially inflated by assuming that the Policy would increase employment through the creation of low-paid jobs. The Model also assumes that redundant public sector workers are re-hired in priority to unemployment claimants and would score no saving in Job Seekers Allowance. This is the only part of the Model where increases in employee compensation are converted to an equivalent number of employees.

By combining the adjusted receipts and adjusted expenditure totals the Model then derives a new forecast for Public Sector Net Borrowing in each tax year and changes to Public Sector Net Debt. As the corollary of the assumption of unaltered government spending, it is assumed that any budget surplus is applied in paying down debt (rather than higher spending).

The Model does not attempt to calculate the impact of the tax saving which entrepreneurs and investors would realise from the exemption from CGT of shares in small companies (and so to that extent it underestimates the effect of the Policy on GDP). There is insufficient OBR or ONS data from which to derive a reliable estimate of how a CGT saving would be used.

In all cases, the Model has used the most cautious assumptions (see Appendix 2).

8.2 The dynamic effects upon enterprise

The results of the Model are described as outcomes on a "static" basis. In other words, the Model adjusts the OBR forecasts on the assumption that all other things remain the same. Adjustments merely reallocate the tax saving made by small companies on the basis of their past behaviour. In reality, this "static" model does include some dynamic effects, such as the incorporation of the self-employed and the impact of rising GDP on Exchequer receipts. However we do not allow for any increase in the entrepreneurial "animals spirits" of the UK.

Profound changes in general business sentiment can have direct effects upon economic performance, most obviously through the levels of private investment. Such changes are often associated with changes in the fiscal stance of the Government. The clearest example of this can be seen by comparing the UK economy during the 1970s and the 1980s. The latter decade experienced a materially higher level of annual growth in private investment (5.2% p.a. compound growth in real terms 1981-1990 compared to 1.8% p.a. compound growth in real terms from 1971 to 1981).

It is inconceivable that a tax change of the scale envisaged by the Policy would not lead to a behavioural change in UK business by boosting overall confidence. But it is difficult to predict what the effect of such confidence would be. Therefore the Model ignores such effects.

For example, over the four years of the forecast period of the Model, we anticipate that investors would make total savings in CGT of £11.4 billion. However, none of this saving is scored as increased consumer spending or as reinvestment because it has not been possible to derive reliable estimates from OBR or ONS data of how the investors would use their savings. Equally, the Model does not include any increase in foreign direct investment arising from the Policy making the UK a more attractive place to start a business.

The results discussed in this Section therefore have to be seen in the light of these omissions which deliberately ignore the additional potential benefits of the Policy.

8.3 Comparison of the Model with the HM Treasury dynamic study

The Model produces results which are broadly comparable to those reported by HM Treasury in their December 2013 paper *Analysis of the Dynamic Effects of Corporation Tax Changes*.

This study considered the net cost of the Coalition's company tax cuts over the period 2010-2015.[19] Using a specially-designed model the Treasury concluded that 45% of the static cost of the changes would be recouped over 20 years by raising the long-term growth rate of the economy.

This is a much slower recoupment than in the Model used here. This is because the HM Treasury study used an idealised steady-state economy rather than the actual details forecast for the UK by the OBR. It is also significant that the Coalition's tax cuts were phased in gradually (which the Model suggests is a less effective approach); and the bulk of the benefit in the HM Treasury approach goes to large companies. This makes the tax cut more expensive to the Exchequer as it is harder to recoup.

Despite a number of technical differences between the Treasury model and the Model developed here,[20] the two models nevertheless arrive at broadly comparable conclusions on the impact of cutting Corporation Tax:

Share of the Tax Saving attributed to:	**HM Treasury Model**	**Policy Model**
Returns to Stakeholders, of which	45%	48%
Increased dividends	0%	17%
Employment Earnings	40%	31%
Price cuts for customers	5%	0%
Return to Capital		
Increased investment	55%	52%

This can be regarded as an independent "sense-check" of the Model as a whole and confirmation that its conclusions are robust.

HM Treasury also believes that its model underestimates the new investment which would result from the lower Corporation Tax rates. It has therefore made a further, off-model adjustment for the "higher elasticity" of foreign direct

19 The estimated cost of £7.8 billion is, coincidentally, broadly the same initial static cost as the Policy itself – see Section 7.

20 See Appendix 2 for full details.

investment which boosts the growth rate and tax recovery. This causes the recoupment to rise to 60% of the original static cost of the tax cuts.

This approach is not replicated in the Model. Instead, it simply relies on official data for all of the forecast effects.

8.4 The results of the Model

8.4.1 Annual growth rate of the UK economy

GDP Growth (at constant market prices)

	2015/6	**2016/17**	**2017/18**	**2018/19**
OBR forecast	+2.4%	+2.6%	+2.6%	+2.4%
Outcome of the Policy	+2.4%	+3.2%	+3.5%	+3.1%

Note: Growth rate measured as OBR headline forecast change in aggregate GDP (chain-linked volume measure) for Q2, Q3, and Q4 of calendar year Y and Q1 of calendar year Y+1 compared to previous tax year's aggregate. Model values prepared on an equivalent basis.

Even allowing for the cautious basis on which the Model has been prepared, there is a clear margin between the growth rate generated by the Policy and that forecast by the OBR. The abolition of tax means businesses are free to spend on reinvestment or hiring additional staff, which boosts overall output.

There is no difference in the growth rate for Year One because the Model prudently assumes that there would be a time lag between a company receiving its tax saving and then spending it. By Year Two a snowballing effect begins to take place. If the Policy were to be continued indefinitely we could expect the long-term trend growth rate of the UK economy to be increased on a more or less permanent basis. (The same conclusion was reached by the HM Treasury study.)

Thus, it is not necessary to rely on the benefits of any assumed cultural change or greater entrepreneurship in order to conclude that the Policy would produce a more vigorous economy. Simply liberating small businesses from tax, and assuming that all other things forecast by the OBR remain equal, will lead to a faster and stronger recovery.

8.4.2 The deficit

The Deficit (Public Sector Net Borrowing, £ billions)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	68.3	41.6	17.7	—1.1
Outcome of the Policy	68.8	44.1	21.8	—2.8

Note: Negative figures represent surpluses. Deficit measured as OBR headline forecast for the Public Sector Net Borrowing including Royal Mail pension fund and Asset Purchase Facility at the end of each tax year (which is not the same as the "underlying deficit", which gives a slightly smaller deficit/larger surplus). Model values prepared on an equivalent basis.

As would be expected, in the initial years the Policy produces a larger deficit than under the OBR Base Case because at first tax receipts would be lower. In later years, however, the stronger economic growth caused by the Policy works through to create rising tax receipts and thus closes the deficit. By the end of the forecast period, the Policy has closed the deficit faster than happens under the OBR Base Case and there is a larger budget surplus.

If anything, it is surprising how small the increase in the deficit at the start of the forecast period turns out to be. Ignoring the conversion of self-employed businesses to company status, the initial static cost of the Policy ought to be about £10.5 billion net.[21] The increase in the deficit is only a fraction of this total, however. Greater economic growth is creating compensating gains for the Exchequer in terms of higher VAT, PAYE and NIC receipts which arrive earlier than the cost is suffered in terms of lower corporation tax (and Self Assessment income tax and CGT) receipts.

21 See Section 7: static costs for corporation tax of £8 billion and of CGT of £3.5 billion, with compensating revenue gains of abolished income tax relief on EIS/VCTs of £0.5 billion and income tax on dividends of £0.5 billion.

8.4.3 The burden of the National Debt

The National Debt (Public Sector Net Debt, £ billions)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	1439	1497	1530	1548
Outcome of the Policy	1439	1499	1534	1546

Note: National Debt measured as OBR headline forecast for the Public Sector Net Debt at the end of each tax year. Model values prepared on an equivalent basis.

Debt/GDP ratio (at market prices)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	78.7%	78.3%	76.5%	74.2%
Outcome of the Policy	78.6%	77.6%	75.3%	72.3%

Note: Debt/GDP ratio measured as OBR headline forecast for the Public Sector Net Debt at the end of each tax year expressed as a proportion of GDP (current prices measure) centred on March, i.e. the aggregate of the Q4, Q1, Q2 and Q3 values either side of the end of the tax year. Model values prepared on an equivalent basis.

The Model indicates the Policy would reduce the burden of the Public Sector Net Debt (as one would expect if growth was higher). Significantly, given the way that UK public borrowing has grown since 2008, by Year Four the national debt is not only lower as a proportion of GDP than under the OBR Base Case, but actually lower in absolute amount also.

Nevertheless, the difference in the absolute value of the Public Sector Net Debt under the OBR Base Case and that under the Policy, with its much stronger growth performance, is comparatively small. In part that is a consequence of the way in which the Model deliberately underscores the benefits of the Policy. Mainly, however, it is a reflection of the scale of the debt problem within the UK public finances: even GDP growth of over 3% p.a. will make only a small dent in the burden of the debt.

8.4.4 Tax revenues

Government Revenues (Total Current Receipts, £ billions)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	675.4	711.0	743.4	777.7
Outcome of the Policy	674.8	707.8	738.2	778.1
Cumulative difference	—0.6	—3.8	—9.0	—8.6

Note: Tax Revenues measured as OBR headline forecast for Total Current Receipts (i.e. including APF and Royal Mail Pension Fund) for each tax year. Model values prepared on an equivalent basis.

These results confirm that the Policy is clearly viable, since it stimulates sufficient growth for total receipts to recover to an amount which is greater than they would have been under the OBR Base Case.

Over the forecast period of four years, the Policy has not quite generated the same aggregate receipts as the OBR Base Case (there is a small shortfall of £8.6 billion). However the direction of travel for current receipts is clear. By Year Four the Policy is generating both GDP and economic growth which are considerably higher than the OBR Base Case. Moreover, in Year Four the expansion of employment earnings alone is raising more extra revenue in terms of PAYE and NIC (£16 billion) than the initial cost to the Exchequer of exempting small companies from corporation tax.

It would be reasonable to expect that in Year Five current receipts would be greater than the OBR forecast and thus, over the life of a five year parliament, the Policy would be broadly cost-neutral even without any increase in entrepreneurial activity.

8.4.5 New jobs created

New Jobs created (to nearest 10,000)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	250,000	250,000	260,000	270,000
Outcome of the Policy	310,000	690,000	900,000	920,000

Note: "New jobs" measured as the difference between the aggregate of the OBR forecasts of private sector and public sector employment for Q1 of each tax year and the aggregate total for Q1 of the previous tax year. Model values prepared on an equivalent basis. Figures rounded down to the nearest 10,000 jobs.

The figures above represent a very significant expansion in employment, and far greater than the OBR are forecasting for the Base Case. But the results should be placed in some context.

There are 4.9 million private sector businesses of all types in the UK. The average workforce per business is currently five staff. The Policy would deliver a meaningful tax abolition for 99% of these enterprises (assuming that all small businesses that could convert to company status do so). Seen in terms of one person being hired by every sixth business (i.e. 85% of UK businesses taking on no new staff at all) in Year Four, the Model's projections appear plausible.

These figures are the most speculative aspect of the Model. That is a consequence of the modelling assumptions forced upon us, principally that new jobs are hired at the average wage for each year forecast by the OBR. In practice, the expansion in employee compensation indicated by the Model might well lead to a rise in wage levels above those predicted by the OBR, which would scale back the number of new jobs created. Equally, however, the Model assumes that, notwithstanding a considerably more vigorous growth in GDP, medium-sized and large employers hire no more new staff than is already counted in the OBR Base Case – which could be regarded as just as unrealistic.

8.5 A gradual implementation?

The Policy is intended to be bold, not least so that it can have a profound cultural effect. But what would happen if it were introduced gradually?

An Alternative Version of the Model has been prepared to estimate the results of a gradual introduction (the headline rate of corporation tax being cut to 16% in 2015/16, to 12% in 2016/17, to 8% in 2017/18, to 4% in 2018/19 and finally abolished in 2019/20). The results are uniformly disappointing. Although this Alternative Version does produce a higher level of GDP growth than the OBR Base Case, and hence a slightly better debt/GDP ratio, it also produces a worse outcome on tax receipts and the deficit.

GDP Growth (at constant market prices)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	2.4%	2.6%	2.6%	2.4%
Outcome of the Policy if implemented on a gradual basis	2.4%	2.7%	2.9%	2.8%

Figures compiled on the same basis as the equivalent table in Section 8.4.1.

The Deficit (Public Sector Net Borrowing, £ billions)

	2015/6	2016/17	2017/18	2018/19
OBR forecast	68.3	41.6	17.7	—1.1
Outcome of the Policy if implemented on a gradual basis	69.1	45.0	20.0	1.0

Figures compiled on the same basis as the equivalent table in Section 8.4.3.

The Table in Appendix 7 shows how under the Policy, the gains to the Treasury arise before the costs are recognised.

The Model therefore suggests that, if the Policy is implemented gradually, the acceleration of GDP growth is achieved at the expense of a worsening deficit. The economy benefits more from the compounding effects of growth on an early and significant tax abolition than from a series of small, phased cuts.

A bold approach is therefore clearly preferable.

8.6 The reliability of the Model

The Model is constructed on a very conservative basis:

- It is assumed that the UK economy follows the general path forecast by the OBR. The Model merely adjusts some of the forecasts for individual items to reflect how they would change if the Policy were implemented from 2015 Q2. These adjustments are derived using data published by the OBR itself, or other official statistics.
- It is assumed that over the forecast period companies will behave in the same way that they did between 2009 and 2013 – a time of lower than average growth. With its "static" approach the Model does not assume a significant behaviour change among UK businesses.
- Under the Policy, investors in small companies will make considerable tax savings on the sale of their shares. The Model does not score any benefit to the economy from investors spending or reinvesting this saving.
- The Model only scores benefits from the re-use of the tax saving by small companies. The higher GDP which the Model indicates flows through directly into higher earnings for all types of business, and hence higher after-tax profits for medium and large companies. In reality, as well as a recovery in headline corporate taxes, their increased profits would lead to greater employment, greater dividends and greater investment than the OBR forecast (and thus even higher Exchequer receipts than the Model suggests). The Model ignores such additional gains.
- It is assumed that government spending follows the announced plans and that the only items which change, either upwards or downwards, are spending on Job Seekers Allowance and government debt interest. In reality, of course, the greater increase in GDP which the Model forecasts would mean that the Exchequer also made considerable savings in income-related welfare payments such as tax credits. The Model ignores such potential savings.
- It is assumed that the Policy has no effect on 26 of the 44 revenue streams within Current Receipts for which the OBR provide forecasts. This group includes items such as air passenger duty where it would be reasonable to assume that higher GDP would lead to higher revenues, as people are able to afford to take more flights. However, to calculate an accurate

adjustment to an item like air passenger duty would require the Model to map a behaviour change for which there is insufficient data in the OBR forecasts. Again, the Model ignores such potential gains.

- A pessimistic view is taken about other tax losses. Once small companies are exempted from corporation tax on their profits, it would create an obvious opportunity for sole traders and the self-employed (who would otherwise be taxed at 20%, 40% or 45%) to convert their businesses into companies. In reality, not everyone would decide to exploit the Policy. For example, when Gordon Brown experimented with a zero starting rate for companies in 2002-2005 not every self-employed businessman turned himself into a company. However, the Model assumes there is 100% conversion of anyone who could qualify as a “small company”. That almost certainly exaggerates what would happen in real life, because in practice the complexity of the tax system means that it can be quite a fine judgment as to whether an individual is better off with self-employed or corporate status. Therefore, the Model includes a significant income tax loss from the self-employed in addition to the static costs of lower corporation tax and CGT revenues.

9. Q&As

9.1 Doesn't the Policy add to the deficit when Britain needs deficit reduction?

In 2012/13 the government borrowed £115 billion.

In 2013/14 the government borrowed £108 billion.

For 2014/15 the government expects to borrow another £96 billion.

Because the annual Government deficit has averaged over £100 billion a year, total Government debt will have grown during this Parliament, a period of 'deficit reduction', from £846 billion to £1.4 trillion.

As the Model shows, the Policy is not advanced as an alternative to the existing government goal of spending restraint and deficit reduction. It is put forward as a more effective method of delivering that goal. By Year Four, the Policy would produce a larger surplus, and a lower National Debt, than the current OBR forecasts.

9.2 £10.5 billion is a big loss of tax revenue for the Government. How will it be made up?

The Government raises over £600 billion each year, and intends to increase this to nearly £800 billion as the economy recovers over the next five years.

The Policy represents at most 1.5% of that total revenue.

A rounding error. And one which, the Model shows, will be quickly erased even without any supposed dynamic effect.

The Policy will generate stronger growth, enabling the Exchequer to collect more PAYE and NIC from higher employment; more income tax from higher dividends to investors; more VAT from additional consumer spending; and more corporate taxes from the medium and large companies who do not benefit from the tax abolition.

There will also be associated savings in Job Seekers Allowance (lower unemployment than forecast by the OBR) and other welfare benefits, and in time savings on government debt interest (a faster reduction of the deficit and a larger budget surplus).

9.3 £10.5 billion is peanuts. How can something so insignificant have an impact equivalent to the sale of Council Houses?

The average UK business has five employees. Businesses with fewer than 50 employees employ 11.4 million people, 47% of all private sector jobs, and are responsible for 33% of all private sector turnover.[22]

However, although larger companies (i.e. those with 50 staff or more) provide the majority of private sector employment in the UK, and the majority of commercial activity, they are not the business sector with the greatest dynamic potential.

A significant feature of the UK's recovery from the recession has been the way that employment has increased. A study undertaken by the Federation of Small Businesses (FSB) found that over the worst phase of the recession, from 2008 Q4 to 2011 Q1, 73% of new jobs in the private sector were created by people moving into self-employment or working for small businesses with fewer than 50 employees. Only 8% of new jobs represented people joining the largest employers, with workforces over 250 employees.[23]

The same study also indicated that smaller businesses have a greater propensity to offer work to the unemployed and non-participants in the labour market.[24] Projecting forward their findings, it is possible to forecast that in an average year a total of 1,322,000 work opportunities would be created in small businesses and self-employment, whilst the corresponding figure for larger employers would be 128,000.[25]

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22 BIS Business Population Estimates for the UK and the Regions 2013 (23 October 2013).

23 Peter Urwin and Franz Buscha *Back To Work: The role of small businesses in employment and enterprise,* Federation of Small Businesses, September 2012.

24 "Non-participants" are 'economically inactive', i.e. not actively looking for or available to work. This includes, for example students, the long-term sick or disabled, retired or those looking after a family or home.

25 These figures are gross of any reduction in total employment caused by redundancies or moving into non-participation e.g. retirement. The figure for new small business jobs comprises 263,000 leaving unemployment to work with a small business; 85,000 leaving unemployment for self-employment; 741,000 leaving non-participation to join a small business; and 233,000 leaving non-participation for self-employment. The figure for larger business employment comprises 65,000 leaving unemployment and 63,000 leaving non-participation.

During the most severe recession for many decades, it has actually been the workforce of small businesses which has expanded, either because they have taken on more staff or because people have left large companies and entered business on their own account. The Policy is a huge financial carrot, being fed to that part of the economy which has the greatest growth potential. As London Stock Exchange chief executive Xavier Rolet has said:

> *Vibrant, dynamic SMEs are the engine of the capitalist economy… Large caps and the public sector have created no new net jobs over the last eight years.*

A Policy which directly benefits over 90% of UK companies (and, potentially, 99% of all UK businesses) will have a significant impact. A £10.5 billion collective saving will make a considerable difference to the small companies for whom tax and regulation are a comparatively more onerous burden and the tax cut is delivered to the sector of the economy where it is likely to generate the greatest return.

Everyone accepts that the sale of council houses had a profound impact on British society. The maximum number of sales in any one year was 167,123 properties in 1982/83 and from the inception of the programme in the Housing Act 1980 ten years had to pass before 1 million households had exercised their Right to Buy.[26] In comparison, in Year One of our Policy at least 1 million small companies, employing approximately 5 million people, will be eligible for the abolition of corporation tax, and another 3 million unincorporated small businesses, employing a further 5 million people, could benefit if they chose to convert into companies.[27] Another contrast is that whilst the Right to Buy liberated people to acquire a new asset (their home) at a discounted price, our Policy liberates people to retain more of an asset (their own money) they have already earned.

The Policy will have an impact at least equivalent to the sale of council houses because it has the potential to reward at least as many people, to do so more immediately and to deliver a benefit to the most dynamic sector of the economy.

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[26] Source: ONS data.

[27] BIS Business Population Estimates for the UK and the Regions 2013 (23 October 2013).

9.4 Won't it mean spending cuts to save £10.5 billion? Won't it lead to fewer doctors and nurses?

Retailers often cut prices in order to boost volume. That can lead to higher profits.

Similarly, cuts in the tax rate can lead to higher tax take in the medium term. The Treasury's document *Analysis of the Dynamic Effects of Corporation Tax Changes* (December 2013) explained that lower tax rates mean higher tax revenue in the long run, more employment, more investment and so on.

The Model which supports this Policy assumes that the cost of the initial tax abolition can be recovered comfortably within the lifetime of a parliament without any reduction in expenditure (other than on unemployment benefits and government debt interest). There would be no need to make any additional spending cuts.

9.5 Nobody ever said we believe in 'laissez-faire'. Don't we just need more regulation?

Big Companies think regulation helps them. It is a competitive advantage.

They laugh about 'compliance costs' only they can afford, which put their new competitors out of business.

Greater regulation increases costs, not just for those businesses being regulated but also for the state bodies which do the regulating. That cost is borne by the citizen, either as a customer or as a taxpayer.

9.6 Don't we just need more prosecutions?

The threat has the reverse effect – a deterrent to small companies, but a benefit to large companies, with multiple domiciles and large international legal departments, advised by the top global accounting firms.

9.7 Aren’t global companies beyond the reach of national governments?

Yes.

Companies have found a way to merge countries for profit purposes.

But countries have not found a way to merge companies for legal purposes. Nor are they likely to. The global corporation can pave over any one country. This is why the American and Chinese Governments support the EU. They say it is easier to deal with America than the EU, because in the EU:

There are too many cooks

They would prefer Europe to be:

One Country with One Government

Because then it would be:

More efficient

The Policy would not benefit global companies directly, other than to make the UK a more attractive place for them to do business because of its stronger, more robust economy. What the Policy would do is to shift economic power within the UK towards smaller businesses so that, in time, greater competition would emerge and cartels would be undermined.

9.8 Aren’t many of the Big Companies natural monopolies which will therefore be unaffected by the Policy?

Up until the 1980s, British Telecom was a natural monopoly – and customers suffered accordingly. Technology – in particular the mobile phone – rapidly destroyed that monopoly.

New technology is already beginning to undermine the banking cartels (think Zopa, Funding Circle and Ratesetter). Big Pharma is being challenged by Little Biotech. Whether small challenger companies can develop new technologies to challenge the water and energy companies is a “known unknown”. But that the Policy will make such a challenge more probable is a “known known”.

9.9 Isn't it impossible for the new kid on the block to compete with giant corporations?

No.

Two men in a garage can do well:

These five companies today have a market capitalisation of over $1.5 trillion. Bigger than the whole of the Russian economy.

9.10 Wouldn’t it make more sense to concentrate on building up Big Companies to compete in “the Global Race”

Britain has had a long and unhappy history of spending money on trying to “pick winners”. Big Government is better at backing losers.

A Big Business has already in some sense succeeded, because that is how it got to be big. A policy which aimed directly at benefiting Big Business would therefore merely reward past performance. That is picking those who won last year’s race.

Policy ought to aim at rewarding future performance and building up future winners. But we do not know what that future will hold.

The solution to Government’s inability to predict the future is to stop trying, step back and let businesses get on with it for themselves. And the sector that is most likely to contain the “unknown unknown” of next year’s new big thing, is small business.

9.11 Not everyone is cut out for all this 'entrepreneurial' activity. Don't some people prefer not to take risks and to be securely employed?

There is no such thing as 'secure employment'. To be employed is a risk. Employees must bow to the will of the market. If it decides to 'save on wages', they are out.

It's the people who rely upon others to provide them with employment who have the most to gain from a tax policy which promotes enterprise and growth. In a world in which there will be fewer high-volume employers, and nobody offers a career for life, people probably will have to expect to spend some periods working for themselves.

If the workers have to adapt to this more fluid economic environment, so should the tax system. The UK still has a tax system which assumes workers remain in post, with their employer deducting PAYE and NIC from their wages, and employing companies pay corporation tax, apart from a few who happen to be small and are allowed to follow slightly more relaxed rules.

A number of recent studies suggest that the younger generation may be more enterprise-minded than their elders:[28]

- Comparing responses to the British Household Panel Survey conducted in 2010 with those from 1998 indicates that the desire to start a new business has risen considerably across all age groups. This is particularly marked among those born between the early 1980s and the mid-1990s, of whom nearly a third expressed entrepreneurial ambitions.
- The number of people actually acting on these desires is, of course, much lower. Nevertheless, figures for the UK from the Global Entrepreneurship Monitor across the period 2002-2011 indicates that people in the 18 to 29 age bracket are now nearly twice as likely to have taken steps to establish their own business as a decade ago.

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[28] See Adam Lent, *Generation Enterprise: The Hope for a Brighter Economic Future*, RSA, 2012.

9.12 Isn't more tax from the rich the solution to the deficit?

There is already a dangerously high level of reliance on a few rich people. Since 1999:

- The top 10% of earners have consistently contributed more than 50% of total income tax revenues (currently, an annual collection of at least £90 billion).
- Within this group, the top 1% of earners have consistently contributed at least 25% (currently the level is just below 30%, or approximately £44 billion).[29]

There is limited scope to extract much more from these groups, who are of course the people best placed to relocate themselves and/or their assets to other tax jurisdictions.

[29] Proportions of total tax contribution taken from HMRC Income Tax Liabilities Statistics 2011/12 to 2013/14, Table 2.4 (released 7 February 2014) and estimates of amounts contributed derived from the forecast income tax receipts for 2013/14 in OBR Economic and Fiscal Outlook, Main Table 4.5 (released 19 March 2014).

9.13 This is just a tax break for the rich. That is not fair, is it?

The Policy is aimed at helping small companies and start-ups to grow. It can, directly and indirectly, benefit everyone from every background and from every part of the country.

The immediate beneficiaries are the owner-managers of small companies, and those traders, self-employed and partners who decide to incorporate their businesses. Some of these individuals may be comfortably well-off already. The vast majority, however, will be business people in quite modest circumstances who simply wish to improve their standard of living.

Any one working for such a business, but not as an owner, still stands to gain from the Policy. It is clearly better to be working for a successful employer who is expanding, and hence in a position to pay higher wages or at least offer greater job security.

But what about low-paid people working for a large employer, or for the state? The results of the Model indicate that the Policy will open up scope for a significant expansion in employment earnings in the small business sector, initially in terms of the number of jobs but ultimately having an effect on wage levels themselves. Employees of large companies may be able to obtain a better job with one of those businesses. Even if he or she doesn't, the employer might have to improve his terms and conditions in order to retain him.

These opportunities will of course be available to state employees. In addition, as the Policy is forecast to result in a faster reduction in the deficit, the public sector finances will be improved to the benefit of all state employees.

9.14 Won't this just take the country back to the 1980s yuppy Loadsamoney culture?

The Policy will encourage the self-employed to incorporate and small successful companies to grow. It will thereby be more likely to encourage responsible, dynamic entrepreneurialism.

It will also do most for those without a job: of those without jobs in 2010, and who have since found private sector jobs, 73% have done so in start-ups or small businesses. In contrast, those who were without jobs and who have since found private sector jobs, only 8% have done so in large businesses.[30]

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[30] FSB, *Back to Work: the role of small businesses in employment and enterprise*, 2012.

9.15 Is this a Conservative Policy?

The Policy is true to the fundamental tenets of Conservatism: a belief in freedom, independence and self-determination.

However, it is put forward in the hope that it will be adopted by all political parties (as indeed eventually happened with the author's previous proposal to increase the income tax threshold to £10,000). This is called "moving the centre ground".

All the main UK political parties are now committed in some form or other to spending restraint and deficit reduction after 2015. Since the Model indicates that the Policy would eliminate the deficit faster than the OBR predict, without requiring any change to the existing government's spending plans, every political party ought to welcome the Policy.

9.16 Isn't the Policy just a re-run of Gordon Brown's failed policy of cutting Corporation Tax for small companies?

Between the tax years 2002/3 and 2005/6 Gordon Brown experimented with a zero-rate band for small company profits, having earlier implemented a lower, 10% band in 2000/1.

It is quite true that his professed motives were similar to the objectives we claim for the Policy:[31]

> *This Budget seeks to build from this a culture of entrepreneurship in every community... And to send out the strongest signal about the importance that we attach to small businesses and the creation of wealth I propose to reduce the 10p starting rate of corporation tax from 10p to zero.*

It is also true that this initiative is generally considered to have been a failure. Gordon Brown later accused businessmen of converting into companies solely to exploit the loophole he had created. So in 2004/5 he introduced a "non-corporate distribution rate" of 19% on dividends paid by companies in the nil rate starting band, which aligned them with the corporation tax rate levied on the smallest taxable companies. Eventually the starting rate was abolished.

However, other than the superficial similarity that they involve some companies not paying corporation tax, the two policies are different in conception and scope:

- Gordon Brown's nil-rate starting band offered very little benefit. Only the first £10,000 of profit was actually exempt, and thereafter the next £40,000 was taxed at a transitional rate before companies paid the original small profits rate (then charged at 19%).

  At those levels, the tax saving generated was never going to be large enough to trigger a renaissance in British enterprise. It would not have allowed a business to afford an extra employee, for instance. Practically the only people who would have been attracted by the new nil-rate were self-employed individuals wanting to avoid tax.

  In contrast, the Policy covers far more substantial businesses, with turnover of up to £6.5 million. This will unlock far greater sums of money

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[31] Hansard *House of Commons Debates 17 April 2002 vol 383 cc577-93 at col. 581.*

and enable employers to undertake considerable expansion. Gordon Brown estimated that his measure would cost less than £265 million,[32] (although the loss was £430 million[33]). The equivalent cost of the Policy is £8,000 million.

- When Gordon Brown discovered that businesses were not behaving in the way that he wanted, he had to introduce a new tax on small company dividends to charge them the equivalent of corporation tax on the underlying profits (reversing the effect of his original measure). Businesses could justifiably feel that they had been misled and their tax compliance was made even more complicated. In contrast, the Policy includes a comprehensive reform of dividend taxation.

- Gordon Brown's measure was bolted on to a pre-existing corporate tax regime whose architecture remained unchanged. Companies paid the full rate on profits over £1.5 million, a lower rate on profits up to £300,000, and a blended rate on profits in between. Those limits had been set by Kenneth Clarke for 1994/95 and were never adjusted.

The Policy will also benefit from the Coalition's corporation tax reforms since 2010. The Policy would be launched in a situation where there would already be a flat-tax of 20% on all corporate profits. That is a simple and historically low rate of Corporation Tax – a fact that significantly reduces the "cliff-edge" effect if the rate were higher.

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[32] Budget 2002, Table 1.2, page 14 (cost of the new 0% band and of reducing the small company rate from 20% to 19% aggregated).

[33] Budget 2007, Table A3.1, page 234.

9.17 Isn't the Policy just a re-run of Gordon Brown's failed policy of tinkering with Capital Gains Tax?

Between the tax years 1998/99 and 2007/8 Gordon Brown experimented with a reduced CGT rate (but not 0%) for "business assets". Even today the CGT rate for individuals is lower than their equivalent income tax rate (basic rate income taxpayers pay 18% as opposed to 20%; others pay 28% as opposed to 40%/45%).

It is quite true that Brown's professed motives were similar to the objectives for our Policy:[34]

> *It is time also for a fundamental reform of capital gains tax... I have decided to phase out complex allowances, and instead I will introduce a new structure of capital gains tax which will explicitly reward long-term investment, and which is based on a downward taper and lower tax rates.*

Gordon Brown's policy became discredited when it emerged that, in the terms publicised by the media, millionaire private equity investors were "paying less tax than their cleaners". The taper relief rules were tinkered with repeatedly, but the essential details were:

- The longer that an asset had been held before sale, the lower the CGT rate.
- "Business assets" were taxed at much lower rates than "non-business assets" – by the end of the scheme, at 10% for assets that had been owned for 2 years or more.
- "Business assets" eventually included any shares in any trading company owned by any director or employee.

Under Gordon Brown's taper relief, then, a private equity fund run by millionaires could take-over a large listed company, strip out some of the assets and sell on the remainder after two years and pay only 10% tax on their gains.

If a private equity fund tried to do the same under our system, they would pay the same CGT rate (18%/28%) as the current tax regime. The exemption is limited to investments in small trading companies, unlike the rules for Brown's taper relief.

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[34] Hansard *House of Commons Debates 17 March 1998 vol 308 col 1101.*

Under our Policy, a millionaire could only “pay less tax than their cleaner” if they invested in a small company, re-invested the profits in building up the business and sold their shares when the company had become more valuable. That is exactly the sort of entrepreneurial behaviour which the tax system ought to be rewarding.

9.18 Isn't it already possible for small companies to exempt themselves from tax through the existing investment allowances and reliefs?

All businesses, not only companies, are eligible for an Annual Investment Allowance (AIA). This allows them to deduct against taxable profits the full cost of certain types of capital expenditure, mainly plant and machinery although there are exceptions.[35] This replaced a system whereby expenditure on plant and machinery only attracted tax relief gradually at a rate which notionally represented the depreciation in value of the assets. The intention behind the AIA is to encourage greater investment but simplifying its tax treatment.

The annual limit on qualifying expenditure was originally set at £50,000 for 2008/9,[36] then increased to £100,000 from 2010/11[37] and then reduced back to £25,000 from 2012/13.[38] However, the Autumn Statement for 2012 introduced a temporary increase to £250,000 for two years from 1 January 2013,[39] and in Budget 2014 it was announced that this would be further increased to £500,000 "from April 2014 until the end of 2015".[40]

A higher AIA will undoubtedly encourage more investment, which is also one of the objectives of the Policy. But AIA only shelters a company from tax to the extent that it spends money on new plant and machinery. What if a business does not require any new capital equipment?

There is also a drawback with the AIA, as part of the overall capital allowances system. When there is a disposal of assets on which allowances have been given, the proceeds of sale have to be taken into account and reduce the amount of any qualifying expenditure which can attract relief at that time. Strictly,

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35 Capital Allowances Act 2001 sections 38A-38B.

36 Capital Allowances Act 2001 section 51A as implemented by Finance Act 2008 Schedule 24.

37 Finance Act 2010 section 5.

38 Finance Act 2012 section 11.

39 Implemented as Finance Act 2013 section 7, with Schedule 1 setting out the detailed transitional rules which apply to businesses whose accounting periods straddle either 1 January 2013 or 1 January 2015.

40 Budget 2014, para 1.102, page 31.

then, the AIA is not a measure which provides complete exemption from tax, but acts partially as only a deferral.

A permanent blanket exemption which also removes small companies from the capital allowances regime altogether, is preferable to a complex and temporary relief based on the fluctuating levels of capital expenditure.

9.19 What happens if companies use the tax saving in ways which the Model does not anticipate, for example by spending it on other things such as cutting their prices or sitting on the cash?

The Model apportions the tax saving between dividends, employee compensation and investment on the basis of the comparative changes in these items relative to what the ONS calls “changes in the aggregate private company operating surplus” over the period 2009-2013. These are cautious assumptions as this was a period when economic conditions were challenging and when HM Treasury was reducing the headline rates of corporation tax.

Because it includes a time lag between the receipt of the tax saving and its reallocation by the company, the Model already assumes that businesses will “sit on the cash” for some time. Consider a company which receives a £100 tax saving in each financial quarter:

	Tax Saving	Dividends	Employment	Investment	Cash Balance
Q1	+£100				+£100
Q2	+£100	—£17			+£183
Q3	+£100	—£17	—£31		+£235
Q4	+£100	—£17	—£31	—£52	+£235

If the tax saving remained constant at £100 per quarter, the company would have permanently increased its cash balances by about half of the annual saving. If the tax saving were to increase, because the company’s profits increased and the business was being exempted from paying a higher tax liability, then the amount permanently held in cash would also increase.

So, the response to the criticism that real companies would respond to the tax abolition by hoarding cash is: the Model assumes that that is exactly what they will do. It does not assume, however, that they hoard 100% of the tax saving forever. The Policy’s approach is thus far more realistic.

Companies do of course spend money on items other than dividends for their owners, wages for their staff or investment. The Model tracks the behaviour of the economy using items which constitute the National Accounts as compiled by the ONS, and for which the OBR provide individual forecasts. So it only has to score alterations when they would appear in those items, as either employment costs, consumer spending or investment. Intermediate transactions do not need to be recognised.

Businesses may also “spend” their tax saving in reducing their prices to consumers. That is an assumption included in the December 2013 Treasury paper on the dynamic effects of corporation tax cuts. The Model does not allow for such effects because it would involve including an assumption about the elasticity of consumer demand which is not easily derived from the OBR forecasts.

These aspects are explained more fully in Appendix 2.

9.20 Shouldn’t Conservatives stop banging on about money?

For the Conservative Party to deny the importance of money is a proof that the Conservative Party is:

> *The party of the rich*

Only a rich man would be so contemptuous of the power of money in people’s lives.

9.21 ‘Ideology’ is not important. Surely, all that matters is economic competence?

After the Second World War, in 1945, voters removed a highly competent war leader.

Apparently, people resented the ‘Officer Class’ – a sense of unfairness and powerlessness.

After this economic war, the ‘Officer Class’ is the banks, energy companies, trains, etc.

This Policy will clearly favour millions of individuals over the established mainstream élite.

9.22 Isn't it a license for tax avoidance?

Yes.

Lower tax is a good thing if it creates jobs and prosperity – from which in the long run the Exchequer will collect far more revenue.

The Model assumes that more or less every self-employed trader who could benefit does convert his business to exploit the tax advantages – and the Exchequer still ends up better off.

If individuals want to provide a tax-free shelter for their business earnings, then let them. They would then face the question of what to do with those earnings. Profits which were extracted as an immediate personal reward would be subject to income tax as before and the individual would make very little net gain on the exercise. The trader only receives a significantly higher tax-free reward if the earnings are retained within the business to finance its expansion, so that it generates a long-term capital gain on a sale. Long-term investment is what the tax system is supposed to encourage.

It is possible that the abolition of CGT will encourage people to game the system. For example, individuals may try to disguise income as capital.

This issue is considered in more detail in Appendix 6, which shows how the Policy would block offensive tax avoidance.

Note that Entrepreneurs Relief already reduces the rate of CGT on small company shares from 28% to 10%. Further reducing the rate to 0% is unlikely to encourage significant avoidance behaviour.

9.23 Won't big companies break themselves up into small companies to get these tax advantages?

No.

The test for eligibility would be one of fact, that a particular small company was not part of a larger enterprise under common ownership and control. A large or medium-sized company could not pass this test by restructuring itself in a way that ticked a series of boxes. It could only qualify for exemption from corporation tax if it genuinely demerged into several smaller businesses which in practice were completely divorced from each other – in which case, it would no longer be a single big business.

See Appendix 6 for details of how the Policy would stop the problem from arising..

9.24 Won't this proposal encourage even more employees to turn themselves into 'IR35 companies' to avoid paying tax?

The 'IR35 problem' arises because there is a differential treatment of employment and self-employment in the tax system. Earnings derived from a contract of service as an employee are subject to income tax, employers' NIC and employees' NIC whereas earnings from a contract for services would be subject only to corporation tax if delivered through a company. The IR35 and associated legislation was implemented to catch personal service companies which are being used as camouflage for work which is in reality employment.

This differential treatment reflects an outmoded view of working practices. There is a rigid distinction between employees, who are assumed to remain with the same employer performing much the same tasks for their whole careers, and sole traders who are assumed to have more variable earnings and greater overheads. The long-term solution to the IR35 problem is therefore to amalgamate the tax and NIC system in a way which reflects modern flexible working patterns. However, such a massive overhaul of the tax system is not politically practicable – and, in any event, is outside the scope of this paper.

'Employment' is a matter of fact as to the precise relationship between the parties. Under the Policy, the onus of proof would be on a small company to demonstrate that it is eligible for exemption from corporation tax. This would involve declaring why the company believed itself to be outside the various IR35 and related provisions. A one-man company would have to disclose sufficient detail to reveal whether there was a risk that employment taxes were being avoided, and hence that follow-up enquiries were needed. HMRC would still have to process and verify each claim, but with corporation tax being abolished for 90% of all companies, internal resource would be available to be redeployed for these purposes.

The process of claiming exemption from corporation tax should force any company being used to avoid employment taxes to incriminate itself. Rather than encouraging greater tax avoidance, our Policy might actually strengthen the enforcement of IR35.

Arguably, the current IR35 and related legislation is in need of overhaul. That is a separate issue that is best handled on its own merits.

This issue is considered in more detail in Appendix 3.

9.25 This Policy may be all very well for Tech City but it will mean nothing to the real economy

The 1,000 most exciting companies identified by the software company Growth Intelligence have had an average revenue growth of 80% over the last three years and span 100 different sectors and every region.[41] Manufacturing accounts for nearly one in five of the list – significantly more than the 105 technology companies represented.

[41] London Stock Exchange Group, *1000 Companies to inspire Britain*, 2013.

9.26 Why are small companies in the financial services sector excluded? Aren't they Britain's most productive sector?

One of the advantages of the Policy is that it is using well-established legal terms and definitions.

It is true that financial services are excluded from the "small companies regime" in the Companies Act 2006, from which the Policy takes its original definition of a qualifying small company. There are good policy reasons for not allowing such businesses to exempt themselves from undergoing an external audit.

But that specific exclusion is not carried over to the Policy. Within the financial sector, only insurance businesses would be specifically outside the exemption from corporation tax. That is because, given the nature of insurance business, such companies already have their own bespoke tax regime and there is no good policy reason for overturning it.

Financial service businesses could still be eligible for exemption from corporation tax if they were small trading companies. The emphasis here would be on the "trading" aspect of the definition. If, as a matter of fact, a business was organised in such a way that its principal activity constituted investment management, then it would not be eligible for exemption – but that ineligibility would come from the fact that it was not a trading company, rather than because it operated in financial services.

This issue is considered in more detail in Appendix 3.

9.27 Does the Policy create a disincentive to growth?

In terms of Corporation Tax, the Policy includes a significant tax incentive to remain a small company: a small company with say 50 employees and turnover of £6,000,000 would pay no Corporation Tax. But if in the next year it took on one extra employee and its turnover increased to £6,500,001 then it would pay 20% Corporation Tax.

This incentive would be counterbalanced by the CGT exemption enjoyed by the owners of the company. They would be keen to see a company grow to increase the value of their shares and would presumably see the long-term benefits of growing the business. Alternatively, it would be a convenient point for the owners to sell the company to a larger (taxable) competitor and then start a new business with some of the proceeds.

Nor should a company which grew to the threshold of corporate tax exemption, and then stayed there, be considered as a failure for the Policy. The "average" business in the UK at the moment has five employees and a turnover of £670,000. That is an indication of the radical inequalities of scale on which most UK business is conducted. If every UK business were a company, around 99% of them would be eligible for exemption from tax under the Policy. They would still be responsible for around 67% of all turnover and over half of all private sector employment.[42]

In addition, if the only thing that the Policy achieved was an expansion of the number of 50-employee, £6,000,000 turnover businesses in the UK, i.e. those keeping just within the threshold of eligibility for tax exemption, then it should still be regarded as a magnificent success.

[42] BIS Business Population Estimates for the UK and the Regions 2013.

9.28 Why is the Companies Act definition of a “small company” used?

The Companies Act definition is well-established. People are already using it. The Policy does not create any new compliance systems which businesses have to follow.

As a regulatory definition it has additional merits. The authorities already concede that businesses of this size do not need to have their accounts audited.

9.29 Wouldn’t this Policy distort the returns available on different types of company?

There are two ways in which an investor makes a return on investment: income yield and capital gain.

Under the Policy, there would be no difference in the dividend yield from small companies and from medium/large ones. Small companies would not be subject to corporation tax, but their dividends would be “unfranked” and would not attract tax credits. The result is that the net yield received by a shareholder is determined by his personal income tax position, not that of the company which pays the dividends. There would be no pressure on a medium/large company to pay a higher dividend in order to compete with the yields available on shares in small companies.

There would remain a distortion in favour of the capital gain from small trading companies. The same underlying pre-tax growth in value of a share would lead to a smaller after-tax return in a medium/large company or in a non-trading company than in a small one. However there is still less distortion of the market by the new system than under the current CGT regime.

9.30 Wouldn't it be more sensible to use the level of profit as the basis of exemption from Corporation Tax?

Profit-based exemption would be the correct approach if the intention was to mimic the income tax system for individuals, e.g. by giving companies an annual allowance which exempted the first £x of profits from corporation tax, as Gordon Brown tried in 2001-2006.

But that would miss the point. The Policy does not aim to leave companies with a little more cash in hand at the end of each year. We want to cause a much more radical shift in the distribution of commercial and financial wealth within the UK away from the orbit of Big Government and Big Business. Gordon Brown's approach did not work.

The existing statutory test of turnover, assets and workforce comprises the fairest means of assessing the economic significance of an enterprise. So they should be used to assess whether a "small" business should be exempt from tax. Exemption based on a combination of turnover/assets/workforce is easier to incorporate into a forward business plan. Businesses would know where they stood from the outset. Managers would be able to say: "I am the captain of my ship".

Profit is less predictable and, strictly, management would not know whether they were exempt for an accounting period until after the accounts for that period had been signed off. This creates the risk that creative accounting would be used to retain tax exempt status. Big Business would, of course, be in the best position to exploit such opportunities by employing armies of advisers.

Because profit is subject to temporary market conditions it would lead to some odd conclusions. For example, because Royal Bank of Scotland made losses, a profit-based exemption system would have qualified it as a "small company" at a time when it was the largest bank in the world.

It is true that, historically, profit has been the basis for assessing corporate size through the tax system. Companies above a certain profit threshold (£1.5 million) paid full corporation tax; those below a lower threshold (£300,000) paid tax at a "small profits" rate; and in between they were charged a marginal rate than was intended to give a smooth transition and avoid creating any disincentive for growth. However this system is being phased out. From April 2015 all companies will be subject to a flat tax on profits at 20%. There is no good policy reason for reversing that change.

9.31 Why does a technical tax change improve freedom, independence and self-determination?

Consider the position of the owner-manager of a small company under the current tax regime.

First, he has to decide whether to pay himself a salary out of the company – and when he does so, the Exchequer charges him employer's NIC for the privilege.

Second, the Exchequer will confiscate 20% of whatever profits the company has generated. This proportion is the same for every company in the UK.

Third, the owner-manager has to decide how to deploy the surviving 80p out of every £1 which the company has earned – should he take it as immediate reward (dividends) or retain it within the company to build up the business?

If the owner-manager has a target standard of living which he wants to enjoy, paying corporation tax means that less value can be reinvested in the company.

Lastly, when the owner sells the business, the Exchequer will treat the gain as quasi-income, and charge CGT, albeit at slightly lower rates than income tax – so that any earnings which were left within the company to increase its value are taxed a second time.

Contrast this with his position under the Policy.

The question about the owner-manager's salary, and its costs, remains the same. Now, however, the owner-manager has 25% more money to hand when deciding how to deploy the full profits which the company has earned.

Thus, if he wishes to enjoy the same target standard of living, the owner-manager will be able to reinvest more money in the business. The company has the potential to increase in value more quickly without prejudicing the owner's quality of life – and without the owner having to go to a bank or other outside source of finance and submit to their conditions. Equally, however, because the company is generating more free cash, it is a more attractive investment proposition for outside finance.

Alternatively, the owner-manager could reinvest the same amount in the business as before and enjoy a higher standard of living by paying himself larger dividends – in which case, he would also pay more income tax to the Exchequer. It would be the owner's decision.

Finally, when the business is sold, the tax system would recognise that its value has been created by the owner-manager deferring enjoyment of some of the profits. Earnings have been reinvested in the company instead of being used for immediate personal reward. Therefore the gain is not a form of income at all, and so it would not be taxed.

Most significantly, the Policy rewards owner-managers who defer taking their reward. If owners pay themselves more dividends, then they will pay more income tax to the Exchequer. But if they defer that reward to an eventual sale, then they will not be taxed. It is said that the true sign that a person has left childhood and become an adult is when they have the maturity to recognise when it is in their interests to defer immediate gratification. On that basis, the Policy provides a tax system which treats businessmen like mature adults and does not assume that they behave like children.

The Policy would extend these benefits to over 90% of companies in the UK – and potentially, if they wanted to convert (and it would be their decision alone), to 99% of all businesses. The effect on the commercial life of the UK will be widespread and profound.

9.32 Doesn't your Policy arbitrarily dictate that all small businesses should turn themselves into companies?

The Policy brings these businesses into the daylight via registration with Companies House. Although anyone running a "cash only business" on the side is unlikely to be too worried about the income tax system, it must help enforcement if there are more people on the record and within an annual filing regime.

It is easier for HMRC to police the exemption and easier for entrepreneurs to shelter trading income from tax if there is a more formal distinction between the business and the business owner. To the argument that this places an intolerable burden on sole traders: it costs £15 to register a new company, and £13 a year thereafter for the annual return.

However, we do recognise that some businesses derive a great deal of benefit from having a non-corporate structure. For that reason, under the Policy, partnerships would be entitled to opt-in to be treated as if they were companies without having to restructure themselves.

The technical detail of this aspect is described more fully in Appendix 3.

9.33 Would the Policy be possible under EU law?

The preferential tax regime for small trading companies, as opposed to medium/large trading companies or any non-trading company, is compatible with EU law. In particular, because it does not distinguish between types of trading activity, the Policy does not infringe the restrictions on State Aid. In that respect it is an improvement to existing tax-privileged schemes such as EIS, SEIS and VCTs which are caught by EU law in this area because they exclude blacklisted trades, to the extent that the legislation governing those schemes cannot be amended without prior Brussels approval.

The new system does not prejudice companies from other EEA states from participating. All companies with a UK presence would be tested for their eligibility on a world-wide basis (i.e. EEA and non-EEA equally). There would be no element of national discrimination.

The Companies Act 2006 definition of a "small company", around which the new system revolves, derives ultimately from EU law[43] and it was adopted to replace a definition in the previous Companies Act 1985 which was considered to be incompatible.

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[43] Accounts Modernisation Directive (2003/51/EEC).

9.34 All economic models are always wrong. Why is yours any better?

It is true that no model can ever replicate the complexity of an economy. However, the Model used here is only intended to show how, under the most cautious assumptions, the Policy will outperform the OBR forecasts even without any dynamic effect.

More emphasis, then, should be placed upon the fact that the Model indicates that the Policy will produce *greater* growth than the Base Case, rather than a forecast that growth would be 3.5%, say, as opposed to 3.4% or 3.6%, or that more employment would be created, rather than a specific number of new jobs. The Model is not primarily intended to be a crystal ball for predicting the future, but a test for assessing which tax regime produces the better outcomes.

Our Model follows the OBR approach, taking the basic forecasts by the OBR and making minor adjustments where appropriate to reflect the effect of the Policy. Fundamentally, its credibility therefore depends upon that of the underlying OBR forecasts.

10. CONCLUSION

British politics resembles war rather than chess. Generals say, the first principle of warfare is:

> *The selection and retention of aim*

Generals say you can't win a war unless the aim is something good in the moral sense. The 'aim' is not control of the air, or the taking of a bridge (they are 'objectives'); the aim is:

> *The mastery of the inside of men's minds…*

so that your troops believe they are fighting for:

> *…a noble object*

Late in his life, Napoleon summed up how wars are won and lost:

> *One part physical. Three parts moral*

So what is required today more than airpower, or financial power, or even manpower, is brain power. So Conservative ideas are more compelling, more penetrating, and wiser, and all the world can see the splendour of our ideals.

What makes human beings special is that they possess the powers of imagination and can raise up in their mind a vision of a better world and a better life. It follows that lofty thoughts and nobler impulses touch the work-a-day lives of everyone. They are an escape from the dreary reality of the actual world – which Bertrand Russell described:

> *Real life is to most men a long second-best, a perpetual compromise between the ideal and the possible*

When a man or woman stands up for an ideal, or strikes out against injustice, people are filled with hope. This is why people of all classes and ages, and at all levels of intelligence, find idealism more inspiring than pragmatism.

Our firmest beliefs are those to which we are most committed, in which we have invested everything. They make up our ideology – take them away and you take away the keystone of the arch or the base of the pyramid.

John F Kennedy described himself, in a brilliant phrase, as:

> *...an idealist without illusions*

As President Kennedy would have said in Austin, Texas on 23rd November 1963:

> *This is a time for courage and a time for challenge. Neither conformity nor complacency will do*

That is what is needed now.

So come on, you Conservatives, this is a call to arms! Man the ideological barricades!

APPENDIX 1: DETAILED RESULTS OF THE MODEL

Table 1 OBR forecasts for the UK economy

£ billion	2015/16	2016/17	2017/18	2018/19
GDP AT MARKET PRICES *	**1789.1**	**1870.2**	**1955.6**	**2042.5**
INCOME ITEMS				
Total Compensation of Employees	**942.3**	**990.0**	**1035.2**	**1080.2**
Gross Operating Surplus of Private Corporations	**347.8**	**356.0**	**369.0**	**382.9**
Other Income	**262.9**	**280.6**	**300.3**	**79.3**
Taxes on Products and Production – Subsidies	**231.8**	**239.5**	**246.9**	**255.3**
Statistical Discrepancy (Income)	**4.4**	**4.4**	**4.4**	**4.4**
EXPENDITURE ITEMS				
Private Consumption	**1187**	**1245.5**	**1307.1**	**1367.1**
Government Consumption	**345.3**	**339.9**	**334.0**	**334.4**
Fixed Investment	**274.8**	**301.5**	**330.4**	**357.5**
Net Acquisition of Valuables	**1.6**	**1.6**	**1.6**	**1.6**
Change in Inventories	**10.5**	**11.0**	**11.4**	**10.6**
Exports	**540**	**576.9**	**616.2**	**656.7**
Imports	**559.6**	**595.6**	**634.1**	**674.4**
Statistical Discrepancy (Expenditure)	**-10.4**	**-10.8**	**-10.8**	**-11.2**

*GDP figures represent the Current Prices measure used by the OBR in their detailed forecasts. Equivalent figures on the Chain-linked Volume measure used to produce the forecasts for annual growth would be:

	2015/16	2016/17	2017/18	2018/19
GDP (Chain-linked volume)	**1620.9**	**1663.2**	**1706.8**	**1747.3**

APPENDIX 1: DETAILED RESULTS OF THE MODEL

Table 2 Model forecasts for the UK economy

£billion	2015/16	2016/17	2017/18	2018/19
GDP AT MARKET PRICES *	1789.9	1880.9	1983.9	2087.0
INCOME ITEMS				
Total Compensation of Employees	943.0	1000.3	1065.7	1134.5
Gross Operating Surplus of Private Corporations	361.1	416.9	459.6	469.0
Other Income	249.5	219.2	205.4	220.4
Taxes on Products and Production less Subsidies	231.8	240.1	248.8	258.7
Statistical Discrepancy (Income)	4.4	4.4	4.4	4.4
EXPENDITURE ITEMS				
Private Consumption	1187.4	1251.9	1326.9	1402.9
Government Consumption	345.3	339.9	334.0	334.4
Fixed Investment	275.1	306.2	338.8	366.7
Net Acquisition of Valuables	1.6	1.6	1.6	1.6
Change in Inventories	10.5	11.0	11.4	10.6
Exports	540.2	580.2	625.1	671.0
Imports	559.8	599.1	643.1	689.1
Statistical Discrepancy (Expenditure)	-10.4	-10.8	-10.8	-11.2

*GDP figures represent the Current Prices measure used by the OBR in their detailed forecasts. Equivalent figures on the Chain-linked Volume measure used to produce the forecasts for annual growth would be:

	2015/16	2016/17	2017/18	2018/19
GDP (Chain-linked volume)	1621.6	1672.7	1731.5	1785.4

APPENDIX 1: DETAILED RESULTS OF THE MODEL

Table 3 OBR forecasts for Exchequer Current Receipts

£ billion	2015/16	2016/17	2017/18	2018/19
CURRENT RECEIPTS, of which:	675.4	711.0	743.4	777.7
Income Tax				
(a) PAYE	148.2	158.1	168.6	179.1
(b) Self Assessment	29.0	31.2	32.8	34.0
(c) Tax on savings income	2.2	2.6	3.0	3.4
(d) Company income tax	1.6	1.6	1.7	1.8
(e) Non-self assessment repayments	-7.4	-7.8	-8.2	-8.5
(f) Other	3.1	3.4	3.5	3.3
NICs				
(a) Employee liability	48.9	52.9	54.9	57.4
(b) Employer liability	66.1	73.3	77.1	80.8
Tax Credits (negative income tax)	-2.5	-1.6	-0.3	0.0
Value Added Tax (VAT)	115.0	119.2	123.3	127.7
Corporation Tax				
(a) Onshore	39.7	40.5	42.1	43.3
(b) Offshore	2.6	2.2	2.4	2.6
Corporation Tax Credits	-0.8	-0.8	-0.8	-0.9
Petroleum Revenue Tax	1.3	1.0	1.0	0.9
Fuel duties	27.2	28.3	29.1	29.8
Business rates	28.7	30.0	30.8	32.3
Council tax	28.0	28.9	29.8	30.8
VAT refunds	13.9	13.4	13.0	12.8
Capital Gains Tax (CGT)	6.7	7.5	8.2	9.0
Inheritance tax	4.3	4.9	5.4	5.8

APPENDIX 1: DETAILED RESULTS OF THE MODEL

£ billion	2015/16	2016/17	2017/18	2018/19
Stamp Duty Land Tax	14.4	15.7	16.8	18.1
Stamp taxes on shares	3.2	3.2	3.3	3.3
Tobacco duties	10.1	10.3	10.6	10.9
Spirits duties	3.2	3.3	3.5	3.7
Wine duties	4.2	4.5	5.0	5.4
Beer and cider duties	3.5	3.6	3.7	3.7
Air passenger duty	3.1	3.3	3.6	3.9
Insurance premium tax	3.3	3.4	3.4	3.5
Climate change levy	2.5	2.3	2.2	2.1
Other HMRC taxes:				
(a) Customs duties	2.9	3.1	3.2	3.3
(b) Betting and gaming taxes	2.5	2.6	2.7	2.8
(c) Landfill tax	1.2	1.1	1.1	1.1
(d) Aggregates Levy	0.3	0.3	0.3	0.3
Vehicle excise duties	5.8	5.7	5.6	5.4
Bank levy	2.9	2.9	2.9	2.9
Licence fee receipts	3.2	3.2	3.3	3.4
Environmental levies	5.9	6.4	7.0	7.8
EU ETS auction receipts	0.4	0.4	0.4	0.4
Other taxes	7.0	6.7	6.7	6.5
Own-resources Contribution to EU	-5.6	-5.2	-5.4	-5.6
Interest and dividends	9.5	12.5	14.7	16.6
Gross Operating Surplus	30.0	31.3	32.6	33.8
Other receipts	-1.1	-1.2	-1.2	-1.3
APF Receipts	7.2	2.9	0.4	0.0

APPENDIX 1: DETAILED RESULTS OF THE MODEL

Table 4 Model forecasts for Exchequer Current Receipts

£ billion	2015/16	2016/17	2017/18	2018/19
CURRENT RECEIPTS, of which	674.8	707.8	738.2	778.1
Income Tax				
(a) PAYE	148.3	159.7	173.6	188.1
(b) Self Assessment	29.0	30.3	27.2	26.8
(c) Tax on savings income	2.2	2.6	3.0	3.4
(d) Company income tax	1.6	1.6	1.7	1.8
(e) Non-Self Assessment repayments	-7.4	-7.8	-8.2	-8.5
(f) Other	3.1	3.4	3.5	3.3
NICs				
(a) Employee liability	48.9	53.5	56.5	60.3
(b) Employer liability	66.1	74.1	79.4	84.9
Tax Credits (negative income tax)	-2.5	-1.6	-0.3	0.0
Value Added Tax (VAT)	115.0	119.7	125.1	130.9
Corporation Tax				
(a) Onshore	38.9	36.8	33.5	33.8
(b) Offshore	2.6	2.2	2.4	2.6
Corporation Tax Credits	-0.8	0.0	0.0	0.0
Petroleum Revenue Tax	1.3	1.0	1.0	0.9
Fuel duties	27.2	28.5	29.5	30.4
Business rates	28.7	30.0	30.8	32.3
Council tax	28.0	28.9	29.8	30.8
VAT refunds	13.9	13.4	13.0	12.8
Capital Gains Tax (CGT)	6.7	4.1	4.4	4.8
Inheritance tax	4.3	4.9	5.5	5.9

APPENDIX 1: DETAILED RESULTS OF THE MODEL

£ billion	2015/16	2016/17	2017/18	2018/19
Stamp Duty Land Tax	14.4	15.8	17.0	18.5
Stamp taxes on shares	3.2	3.2	3.3	3.4
Tobacco duties	10.1	10.3	10.6	10.9
Spirits duties	3.2	3.3	3.6	3.8
Wine duties	4.2	4.5	5.1	5.5
Beer and cider duties	3.5	3.6	3.8	3.8
Air passenger duty	3.1	3.3	3.6	3.9
Insurance premium tax	3.3	3.4	3.4	3.5
Climate change levy	2.5	2.3	2.2	2.1
Other HMRC taxes:				
(a) Customs duties	2.9	3.1	3.2	3.4
(b) Betting and gaming taxes	2.5	2.6	2.7	2.8
(c) Landfill tax	1.2	1.1	1.1	1.1
(d) Aggregates Levy	0.3	0.3	0.3	0.3
Vehicle excise duties	5.8	5.7	5.6	5.4
Bank levy	2.9	2.9	2.9	2.9
Licence fee receipts	3.2	3.2	3.3	3.4
Environmental levies	5.9	6.4	7.0	7.8
EU ETS auction receipts	0.4	0.4	0.4	0.4
Other taxes	7.0	6.7	6.7	6.5
Own-resources Contribution to EU	-5.6	-5.2	-5.4	-5.6
Interest and dividends	9.5	12.5	14.7	16.6
Gross Operating Surplus	30.0	31.3	32.6	33.8
Other receipts	-1.1	-1.2	-1.2	-1.3
APF Receipts	7.2	2.9	0.4	0.0

APPENDIX 1: DETAILED RESULTS OF THE MODEL

Table 5 OBR forecasts for Government expenditure, deficit and debt

£ billion	2015/16	2016/17	2017/18	2018/19
EXPENDITURE				
Resource Departmental Expenditure Limits	**312.5**	**302.5**	**292.1**	**289.1**
Annual Managed Expenditure:				
(a) DWP unemployment benefits	**3.4**	**3.3**	**3.2**	**3.2**
(b) Government debt interest	**59.1**	**65.1**	**71.6**	**75.2**
(c) other AME	**316.5**	**327.9**	**339.5**	**351.9**
Public Sector Gross Investment	**51.9**	**53.8**	**53.0**	**53.5**
Royal Mail pension fund/APF costs	**0.3**	**0.0**	**1.7**	**3.7**
Headline Total Managed Expenditure	**743.7**	**752.6**	**761.1**	**776.6**
CURRENT RECEIPTS	**-675.4**	**-711.0**	**-743.4**	**-777.7**
PUBLIC SECTOR NET BORROWING	**68.3**	**41.6**	**17.7**	**-1.1**
PUBLIC SECTOR NET DEBT	**1439.0**	**1497.0**	**1530.0**	**1548.0**

APPENDIX 1: DETAILED RESULTS OF THE MODEL

Table 6 Model forecasts for Government expenditure, deficit and debt

£ billion	2015/16	2016/17	2017/18	2018/19
EXPENDITURE				
Resource Departmental Expenditure Limits	312.5	302.5	292.1	289.1
Annual Managed Expenditure:				
(a) DWP unemployment benefits	3.4	2.5	1.9	1.8
(b) Government debt interest	59.1	65.2	71.8	75.4
(c) other AME	316.5	327.9	339.5	351.9
Public Sector Gross Investment	51.9	53.8	53.0	53.5
Royal Mail pension fund/APF costs	0.3	0.0	1.7	3.7
Headline Total Managed Expenditure	743.6	751.9	760.0	775.4
CURRENT RECEIPTS	-674.8	-707.8	-738.2	-778.1
PUBLIC SECTOR NET BORROWING	68.8	44.1	21.8	-2.8
PUBLIC SECTOR NET DEBT	1439.5	1499.5	1534.1	1546.1

APPENDIX 2: THE FINANCIAL MODEL

How the Model works

The Model follows an "OBR Plus" approach. No attempt has been made to produce an independent forecast of the future behaviour of the UK economy. Instead, the OBR's forecasts for the various components of GDP are adjusted to reflect the impact of the Policy. Any element in the original forecasts which is not directly adjusted in this way is assumed to continue as predicted by the OBR.

By matching up the OBR forecasts for each component of GDP with their forecasts for the receipts generated by each tax it is possible to derive estimates for each tax year of the effective rates of PAYE, NIC (employees' and employers'), Self Assessment income tax, VAT, CGT and the corporate taxes which would be suffered by small companies, oil companies and large non-oil companies. Because of the impact of allowances, exemptions and reliefs (for example in the case of VAT, the exemption and zero-rating of certain goods and services) and also because of definitional differences (for example, between "profits chargeable to corporation tax" in the tax system and "Gross Operating Surplus of Private Corporations" for National Accounts purposes) the effective rates are all lower than the headline rates contained in the tax legislation.

At the heart of the Model is the basic identity:

GDP (Income) = GDP (Expenditure)

Increments are made to the base case OBR forecasts for the major components of each side of the equation by reallocating portions of the corporate Tax Saving. This results in a new estimate for GDP.

From the initial starting period, 2015 Q2, the Model takes the OBR forecast for the Gross Operating Surplus of Private Corporations and identifies the proportion attributable to small companies. Under the current tax regime, companies would have to retain part of their earnings to be paid over later to HMRC as tax (the precise timing of such payment depending on the size of the company). Under the proposed Policy, however, eligible companies know that they are exempt from tax and this saving becomes immediately available for use on other purposes. The Model derives the amount of this tax saving. It is then reallocated as other expenditure.

The Policy exempts small companies from corporation tax for their accounting periods beginning on or after 1 April 2015. Thus, at the start of the Policy in 2015 Q2 there will be

some small companies which are immediately exempt from tax on their profits, and others which will be part-way through an accounting period for which they will still have to pay tax. Therefore, using data from Companies House about corporate year-end dates, the Model tracks small companies and only scores tax savings when the businesses would actually become eligible for exemption.

Suppose for a particular quarter the share of Gross Operating Surplus attributable to exempt small companies was £20 billion, and the effective corporation tax rate on small companies for that period was 10%. These would not be untypical numbers for the start of the Policy.

Gross Operating Surplus of Small Companies	£20,000,000,000
Corporation Tax due under current tax regime	(£2,000,000,000)
After-tax earnings under current tax regime	£18,000,000,000

The Model is not concerned with what happens to the £18 billion. It is assumed that this is already reflected in the existing OBR forecasts. What the Model does is reallocate the £2 billion tax saving.

By studying data from the OBR and the ONS for the UK economy since 2009, it is possible to build a picture of how companies would react to an increase in their disposable earnings. This reference period has been chosen because it is both sufficiently long enough to derive meaningful estimates and sufficiently close to the forecast period for the estimates to remain valid. This interval covers a time during which the UK economy is known to have been performing poorly (so we are not making over-optimistic assumptions about the rate of recovery). It is also a period during which HM Treasury was cutting the headline rates of corporation tax (so it provides a reasonable illustration of how companies react during a period of tax cuts). These estimates are derived from hard data of how companies have really behaved in the very recent past.

From the marginal changes observed since the trough of the recession the Model assumes that a tax saving of £2 billion in a given quarter Q would be applied:

£347,547,000 paid out as windfall dividends to the owner-managers in the quarter Q+1

£624,378,000 paid out as additional compensation to employees in the quarter Q+2

£1,028,075,000 paid out as extra investment in the quarter Q+3

The Model therefore assumes that the initial reaction of the companies is to hold the tax saving as part of their cash reserves and to only expend it gradually over the financial year – a period during which the businesses will be receiving further tax savings in successive quarters. Thus, a tax saving on earnings generated in, say, 2016 Q2 would not be fully expended until 2017 Q1. This is a cautious and conservative assumption. We are not assuming that businesses will suddenly embark on an immediate spending spree. Nor are we assuming an outbreak of public-spirited altruism since the first reaction which the Model forecasts is that entrepreneurs would increase their own rewards.

(The Model also tracks the proportion of private company Surplus generated by the oil sector, because those businesses pay separate taxes.)

Because small companies would now be exempt from tax on their profits this would give them a considerable commercial advantage compared to unincorporated traders and partnerships. It is reasonable to assume that such businesses would turn themselves into companies in order to exploit the new tax system. That was the reaction which occurred over the period 2000/1 to 2005/6 when Gordon Brown experimented with low or zero starting rates of corporation tax.

Using HM Treasury data from that time, the Model includes an estimate of how much business would convert to company status. The Model assumes that the level of conversion would be much higher than observed during 2000/1 to 2005/6 and that the process would gather momentum over time. That accords with a reasonable common sense expectation, although by assuming that there would be 100% conversion of any business which would qualify as a "small company" the Model deliberately exaggerates the effect that would take place in real life. Such converted businesses are included within the small company sector, but the initial tax saving is calculated by reference to the effective income tax which the businesses would have suffered under Self Assessment.

It is possible to use OBR data from the same reference period to derive an estimate of how much of the after-tax dividends and after-tax employee compensation would be reflected in higher consumption spending by households, and when, and the corresponding increases in VAT receipts. Together with the amounts derived from the tax savings made by existing and converting small businesses these increments are added to the OBR forecasts for each component of GDP for the relevant quarter. Previous amounts scored as extra employee compensation are uprated in line with the OBR's forecast for future wage rates, to avoid over-estimating the level of company surpluses. This results in a new recalculated value for GDP in future quarters and thus a new forecast for the Gross Operating Surplus of all companies, from which the cycle recommences.

In parallel there is a recalculation of the revenue effect for the separate items which OBR include within their forecasts for the Exchequer's current receipts. This takes account of any relevant impact from the adjusted levels of employee compensation, consumption spending, operating surplus of companies still within the corporate tax net, a significant transfer of businesses out of income tax Self Assessment and other consequences of an adjusted GDP level.

Government spending is assumed to remain exactly as forecast by the OBR apart from the cost of Job Seeker's Allowance (which is adjusted for the new employment levels) and debt interest payments (which is adjusted to reflect the new difference between total expenditure and current receipts).

The new employment level is derived by assuming that each new worker is hired at the "average wage" for each quarter forecast by the OBR, i.e. the fall in unemployment is not artificially inflated by assuming that the Policy would increase employment through the creation of low-paid jobs. A further check is made by comparing the OBR forecast for employment in the private and public sectors. If in any quarter the OBR forecast that there would be more job losses from the public sector than new jobs created in the private sector, then the Model assumes that people in this surplus are re-hired in priority to unemployment claimants and would score no saving in Job Seekers Allowance. This is the only part of the Model where increases in employee compensation are converted to an equivalent number of employees.

By combining the adjusted receipts and adjusted expenditure totals the Model then derives a new forecast for Public Sector Net Borrowing in each tax year and changes to Public Sector Net Debt. As the corollary of the assumption of unaltered government spending, it is assumed that any budget surplus is applied in paying down debt (rather than permitting an expansion of spending).

The Model's forecasts assume that corporate behaviour continues as it has in the recent past since 2009. It does not include any change in business culture. Nor does the Model score any reallocation of the tax saving which entrepreneurs would realise from the exemption from CGT of shares in small companies (and so to that extent it underestimates the effect of the Policy on GDP). There is insufficient OBR or ONS data from which to derive a reliable estimate of how a CGT saving would be used by investors.

The Model reallocates the tax saving between dividends, employee compensation and investment. In the real world, of course, companies spend money on items other than dividends for their owners, wages for their staff or investment. The Model tracks the

behaviour of the economy using items which constitute the National Accounts as compiled by the ONS, and for which the OBR provide individual forecasts.

That framework assumes that all income balances against all expenditure. It is therefore possible to aggregate all items of income and expenditure in the same category without having to distinguish them at the level of the individual firm or worker. All the Model does is reallocate sums between national aggregates. So it only has to score alterations when they would appear in one of the relevant aggregates.

"Private Corporation Operating Surplus", which the Model tracks as the base for corporate taxes, comprises all corporate turnover sums which do not relate to employing people. A tax cut is scored as an addition to this operating surplus. If a company expended part of its surplus on something which was not employee compensation or investment, then it has purchased goods or services from another business.

- If that business is another company, all that has occurred is a switch within Private Corporation Operating Surplus. The global total has not altered. Eventually, however, it will arrive in the hands of a company which does spend it on one of the three elements which the Model tracks.
- The Model does not identify which company pays a particular dividend at a particular time. It merely states that, taking the UK economy as a whole, from an aggregate tax saving of £A for all small companies there will be aggregate extra dividends of £B after one quarter, aggregate extra employment costs of £C after two quarters and aggregate extra investment of £D after three quarters.
- If that other business is not a company, then there would be a corresponding increase in the National Accounts item known as "Mixed Income", which broadly represents the turnover of the self-employed and non-corporate enterprises. They would pay income tax on these amounts. However, about 90% of such businesses would be eligible as small companies if they converted.
- The Model assumes that this is what happens. So, to all intents and purposes the expenditure would count the same as if it had been paid to another company and be absorbed within Private Company Operating Surplus. In theory, a slice of the expenditure ought to be scored as an increase in residual Mixed Income. However, in order to maximise the tax loss of the self-employed converting themselves into companies (and so to score the benefits of the Policy as narrowly as possible) this aspect is ignored.

Company dividends are not an item which is forecast separately by the OBR. However it is possible to estimate the level which would be paid using ONS data. In the Model the dividends are used as a means of passing income to owner managers and reconverting part into extra income tax receipts for the Exchequer and extra consumer spending. We have allowed for dividends in the Model because, given that there is likely to be a high degree of conversion into company status to exploit the Policy, the modelling ought to have a channel which reflects owner-managers rewarding themselves as opposed to sharing the tax saving with their workforce.

The assumptions underlying the Model

- There is no change in Government spending, except in regard to Job Seekers Allowance and debt interest, as a result of the Policy.
- The OBR forecasts for wage levels, inflation as measured by the RPI All Items Index and interest rates are unaffected by the Policy.
- The OBR forecasts for the Operating Surplus of Households, the Operating Surplus of General Government, the Operating Surplus of Public Corporations, General Government Fixed Investment, Net Acquisition of Valuables, Change in Inventories, and the two Statistical Discrepancies are unaffected by the Policy.
- For any Quarter, under the Policy Exports stand in the same relationship to GDP as the OBR forecast for that Quarter.
- For any Quarter, under the Policy Imports stand in the same relationship to Total Domestic Demand as the OBR forecast for that Quarter.
- No company eligible as a “small company” under the Policy currently pays corporation tax on the quarterly instalment basis, and no company which would be ineligible currently pays corporation tax on the annual basis. This position does not change once the Policy is implemented.
- Corporate turnover and company accounting year-end date are independent of each other.
- Small financial services trading companies (as opposed to non-trading investment companies) are not a material proportion of all businesses.
- Business owners pay themselves higher rewards exclusively through dividends.
- New employment is represented by hiring an “average worker” on average wages.
- Once increments in employee Compensation have been scored, employers

continue to fund increases on those amounts in line with the OBR forecast for wage rises.

- The Policy does not affect what private companies do with the amount equivalent to their after-tax earnings under the current tax regime i.e. the Policy is only concerned with what happens to the Tax Saving.
- The difference between the headline rate of corporation tax on small companies and the headline basic rate of income tax, together with the size of the small company sector, determines the value of business which converts from self-employed to company status.
- The National Accounts items Mixed Income and Non-Labour Income constitute the tax base for Self Assessment income tax.
- The effective rates of Self Assessment income tax for 2010/11 and 2011/12 stand in the same ratio as the effective rates of PAYE for those years.[44]
- The OBR forecasts for income tax receipts are net of relief attributable to the EIS (Enterprise Investment Scheme) and VCTs (Venture Capital Trust) schemes.
- The Policy would not affect (either positively or negatively) the OBR forecast receipts for tax on savings income; company income tax; Non-Self Assessment repayments; other income tax; tax credits (negative income tax); business rates; council tax; VAT refunds; tobacco duties; air passenger duty; insurance premium tax; climate change levy; betting and gaming taxes; landfill tax; aggregates levy; vehicle excise duties; bank levy; licence fee receipts; environmental levies; receipts from the EU ETS scheme; Other Taxes; the EU own-resources contribution; interest and dividends receivable by central government; the Government Operating Surplus; other receipts; and Asset Purchase Facility receipts.
- The following tax receipts are sensitive to changes in GDP: fuel duties; inheritance tax; stamp duty land tax; stamp duty on shares.
- The following tax receipts are sensitive to changes in Private Consumption: spirits duties; wine duties; beer and cider duties.
- The following tax receipts are sensitive to changes in Imports: customs duties.

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[44] This assumption is made solely in order to simplify the derivation of the effective rate of income tax. It does not materially alter the results of the Model.

- Capital gains tax (CGT) receipts may be forecast by assuming the existence of a notional pool of chargeable gains whose value is sensitive to changes in GDP.
- The OBR forecast claimant count for each year represents a separate pool of unemployed individuals.
- Any overshoot or undershoot in the OBR forecast for Public Sector Net Borrowing results in a direct and equal increase or decrease in Public Sector Net Debt.
- Interest on Public Sector Net Debt is paid twice-yearly.

Comparison of the Model with the HM Treasury dynamic study

Alongside the 2013 Autumn Statement HM Treasury published a study, *Analysis of the Dynamic Effects of Corporation Tax Changes,* considering the net cost of the Coalition's company tax cuts over the period 2010-2015. These changes reduced the tax rate on medium/large company profits by 8% and on small company profits by 1%. This was estimated to have a headline cost of £7.8 billion, which is broadly equivalent to the anticipated static cost of our Policy.[45] Using a specially-designed model the study concluded that 45% of the static cost of the changes would be recouped over 20 years by raising the long-term growth rate of the economy. If an off-model adjustment is made to account for increased foreign direct investment, this rose to 60% recovery.

The Treasury Model is not meant to forecast the immediate future. It is a long-run macroeconomic model based on a large amount of data about the relationships between all the sectors of an economy with the same essential features as that of the UK. This idealised economy is assumed to grow at a steady annual rate.

The Treasury Model assumes that a cut in corporation tax increases the return on the capital employed. This encourages an increase in investment until the marginal cost is equal to the present value of future marginal return (para 4.17, page 22). There is an initial labour-substitution effect, as businesses use expenditure on new equipment to replace workers at the margin, but this is reversed as the increase in capital stock requires a greater workforce to service it (para 4.23, page 25). Lower taxation allows a degree of price-cutting (para 4.26, page 25) and higher household incomes leads to higher consumption (para 4.24, page 25). The effect is to raise the long-term trend growth rate.

HM Treasury believes that its model underestimates the new investment which would result from the tax cuts (para 4.14, page 22). It has therefore made a further, off-model

45 See Section 7.

adjustment for the "higher elasticity" of foreign direct investment (para 4.33, page 27) which agreeably boosts the growth rate and tax recovery even more.

For the purposes of this paper, there would be no point in our devising a model on the same basis as HM Treasury. That would have no greater or lesser credibility than forecasts made by any other commentator. In the context of UK tax policy, the only forecasts which really matter are those made by the OBR.

To demonstrate that the Policy is viable, it has to "beat the OBR". There is nothing to be gained in devising an alternative model with its own theoretical basis. That means devising a Model which estimates how the OBR forecasts would change if some of the variables were altered in line with the Policy, *all other things remaining equal*.

There is therefore a contrasting approach between HM Treasury and ourselves:

Treasury dynamic model	**The Model**
1. Calculate the tax cut	1. Calculate the tax abolition
2. Recalculate the new return on capital and increase Investment for new capital generated by the increased return on capital	2. Apportion the tax abolition into: • Dividends • Employment costs • Investment
3. Increase wages for labour's share of the tax cut	3. Pay dividends to owner-managers
4. Reduce prices to reflect lower production costs for consumers' share of the tax cut	4. Increase Employment costs
5. Increase/decrease Employment to reflect the new capital stock level	5. Increase Investment
6. Increase Consumption for the new Employment level and lower consumer prices	6. Increase Consumption to reflect the new Employment level and owner-manager earnings

The Treasury Model assumes that one of the channels through which corporation tax cuts affect GDP is a reduction in headline prices to consumers, although the effect is not uniform across all business sectors and varies with capital-intensity (para 4.26, page 25). Our Model does not allow for such effects because we are tied to our core assumption of following the OBR forecasts for variables such as inflation and price levels. We cannot assume any additional demand or consumption from a price cut because that would involve importing an external assumption about the elasticity of demand which could not be derived reliably from the OBR forecasts. (Equally, however, it means that our Model cannot score any increased output which is directly caused by

the unwinding of the deadweight costs of taxation, and can only rely on second-order effects created by reallocating value to consumption.) So, to the extent that in the real world businesses would spend part of their tax saving in reducing their prices, in the Model this would result in the same value of consumption acquiring more units of goods or services, and businesses would receive the same total income.

The Treasury Model does not explicitly refer to the payment of higher dividends by owner-managers. In their analysis, dividends, as a return on capital, are driven by the mathematical formula which calculates the increased levels of investment. Thus, the Treasury Model subsumes dividends within the incidence of the tax cut which is attributable to capital. The Model incorporates dividends as a separate item because we consider that, as a matter of practical reality, the first reaction of owner-managers to a tax abolition will be to treat themselves to a windfall reward – and the modelling ought to reflect that fact.

Allowing for these methodological differences, the two models nevertheless arrive at broadly similar conclusions as to how the tax saving would be shared. There is extremely close agreement as to the incidence of the tax saving which would be attributable to investment. The difference between the two models over the return to labour is reduced if dividends are seen as being a reward for managers (which is how the Model regards it) rather than a return for investors.

Share of the Tax Saving attributed to:	**HM Treasury Model**	**Policy Model**
Returns to Stakeholders, of which	45%	48%
Increased dividends	0%	17%
Employment Earnings	40%	31%
Price cuts for customers	5%	0%
Return to Capital		
Increased investment	55%	52%

The two models are also generating different outputs. The Treasury Model is producing an idealised set of results which would be applicable to an economy with the broad characteristics of the UK, and are applicable in more or less any situation. Their results are stated in constant 2012/13 prices. On the other hand, our Model is tied specifically to the circumstances of the OBR forecast, and so would conceivably produce different results in the environment of a radically different forecast. We also produce results in terms of nominal GDP on the current prices measure, because that is the one used by the OBR in their detailed forecasts.

It is still possible to compare the respective outputs. The Model attributes higher proportions of the GDP increase to consumption and employment than the HM Treasury study, and a lower proportion to investment. That is probably a fair reflection of the recent history of the UK economy since the recession, in that investment has been low but employment has held up, and recovered, far better than anticipated.

Share of GDP increase	HM Treasury Basic model	HM Treasury Enhanced model	Policy Model
Investment	38%	51%	**21%**
Consumption	62%	49%	**81%**
Employment*	111%	111%	**122%**

*The Treasury paper does not give explicit figures for employee Compensation, only per household figures. Those estimates are scaled up on the basis of the number of UK households in 2012/13.

The most obvious differences between the two sets of results however lies in the rate of recoupment of the tax cuts. The HM Treasury study suggests a recovery of 60% of the cost over 20 years, whereas the Model indicates that the Policy would pay for itself in the life of a single Parliament. In part, this difference reflects different assumptions: the Treasury model assumes that the economy follows a steady underlying trend rate, whereas the Model follows the core predictions of the OBR for 2015-2020, which has a higher growth rate.

The main reason is that the two studies are of course modelling different tax changes. The Coalition's Corporation Tax cuts were phased over the period 2010-2015. The alternative version of the Model (see Section 8.5), which forecasts the results if the Policy were implemented over five years, shows how the Exchequer misses out on the significant compounding effect on GDP of a heavy up-front tax cut.

There is also a different incidence of benefit. Most of the gains under the Coalition tax cuts went to larger companies. Both approaches indicate that higher GDP growth leads to greater total company profits which enables the Exchequer to collect compensating revenue gains. But because the majority of taxable profits are generated by larger companies, it requires a disproportionately higher GDP growth rate to recoup cuts from larger companies. Since the Treasury model assumes steady trend growth, it will inevitably forecast that a much longer timeframe is needed to recoup the cost of the 2010 to 2015 tax cuts.

APPENDIX 3: ABOLITION OF CORPORATION TAX FOR SMALL COMPANIES

How would the Policy work?

With effect for accounting periods commencing on or after 1 April 2015, any trading company would be exempt from corporation tax on profits for Year Y if it qualified as a "small company" in Year Y-1.

The definition of "small company" would be taken from the small companies regime set out in Companies Act 2006. An individual company qualifies[46] if it has two out of:

1. Turnover of not more than £6.5 million
2. Gross assets of not more than £3.26 million
3. Not more than 50 employees

The parent company of a group qualifies[47] if the consolidated group as a whole has two out of:

1. Turnover of not more than £6.5 million net or £7.8 million gross
2. Gross assets of not more than £3.26 million net or £3.9 million gross
3. Not more than 50 employees

The Companies Act 2006 definition does not cover certain types of companies, and groups containing such companies.[48] The exclusions relate mainly to financial sector businesses, but the status of the company is also relevant:

- A company which has PLC status (whether it is listed or not)
- A body corporate (other than a company) whose shares are listed in an EEA State
- An authorised insurance company
- A banking company
- An E-money issuer
- An investment firm regulated under the Markets in Financial Instruments Directive ("MiFID")[49]

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[46] Companies Act 2006 section 382.

[47] Companies Act 2006 section 383.

[48] Companies Act 2006 section 384.

[49] Directives reference: 2004/39/EC, 2007/44/EC and 2008/10/EC.

- Management companies regulated under the Undertakings for Collective Investment in Transferable Securities Directive ("UCITS")[50], in effect what are commonly called unit trusts and/or funds
- A company which carries on insurance market activity
- An entity with permission to undertake "regulated activities" under the Financial Services and Markets Act 2000.[51]

The small companies regime in Companies Act 2006 describes companies which, among other things, are excluded from the automatic obligation to submit their accounts to outside audit. There are clear and obvious policy reasons for requiring companies in the financial services area, or ones whose shares are listed on a stock exchange, to be subject to external audit. There ought to be outside checks on how the insiders use other people's money. That is why such businesses are excluded from the Companies Act definition. That reason does not necessarily carry over into the taxation arena.

We would not carry over the automatic exclusion for PLC and listed companies, i.e. they would remain eligible for exemption from corporation tax. The policy reason for our new system is to provide assistance to trading companies which are below a certain threshold of economic significance (measured by turnover, assets and workforce). There is no good reason to disqualify a company from this because it happened to have the legal status of a PLC rather than a private company, or if its shares were listed as unopposed to unlisted. The important distinction between these types of company relates to their governance standards, and those standards and distinctions are enforced through other means than the tax system.

The concept of a "trading company" (i.e. one established in order to carry out a trade), as opposed to an investment company, is already well enshrined in existing tax legislation and practice. A considerable body of case law has built up governing whether a company is "trading" or "non-trading". These precedents would continue to apply to judge eligibility for exemption from corporation tax. There are also established means for assessing the status of a company which has both trading and non-trading activities.

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[50] Directives reference: 2001/107/EC and 2001/108/EC.

[51] Financial Services and Markets Act 2000 Schedule 2 defines these as dealing in investments; arranging deals; accepting deposits; safeguarding and administering assets; managing investments; providing investment advice; operating collective investment schemes; and using computer-based systems for giving investment instructions.

In some cases, such as property companies, it can be difficult to draw the distinction between "trading" property development and "non-trading" property management, and the judgment can be influenced by the legal formalities followed by the business. But these issues exist already within the tax system (because the trading/non-trading distinction already exists). The Policy does not create any new difficulties for either taxpayers or HMRC.

We would not carry over the automatic exclusion of all categories of financial services. Some elements of financial services would qualify as trading and some would not. Our intention is to assist trading companies of a particular size without necessarily favouring one business sector over another. We are not in the business of "picking winners".

That said, the following areas would be excluded automatically from the corporation tax exemption:

- Companies engaged in oil and gas extraction activities in the UK or on the UK Continental Shelf
- Corporate members of Lloyds of London and insurance companies

Oil and gas extraction is already subject to sector-specific tax legislation.[52] So are the various elements of the insurance industry (although not consolidated in a single piece of legislation[53]). There is no good policy reason for overturning these arrangements. (In any event, it is unlikely that participants in these areas would qualify.)

There is also the issue of personal service companies. "IR35" is the colloquial name attached to a series of measures first introduced by Gordon Brown in 1999.[54] The essence of these measures is to identify individuals who are in substance employees but have disguised this through the legal form of an intermediate company. There may

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52 Oil and gas industry: principally Corporation Tax Act 2010 Part 8 (sections 270-357).

53 Insurance companies generally: Corporation Tax Act 2009 Part 5 Chapter 10 (sections 386-394), Part 7 Chapter 6 (sections 634-636), Part 8 Chapter 17 (sections 901-905), Part 13 Chapter 6, among others. Corporate members of Lloyd's: Finance Act 1994 Part IV Chapter V (sections 219-230).

54 The name derives from the reference number of the Budget 1999 press release, *Countering Avoidance in the Provision of Personal Services*. The legislation is now comprised in Income Tax (Earnings and Pensions) Act 2003 Part 2 Chapter 8 (sections 48-61). Finance Act 2007 further extended the scope of anti-avoidance measures by adding Income Tax (Earnings and Pensions) Act 2003 Part 2 Chapter 9 (sections 61A-61J) to catch "managed service companies" where there is an intermediary acting as broker between the worker/personal service company and the end client.

well be an argument that the precise details of these measures should be amended. The basic principle, however, is sound and such entities should not benefit from a measure intended to assist genuine trading companies.

The “IR35” provisions would therefore remain in force. Where a small company was being used to camouflage a real employment relationship then the company would be subject to tax charges equal to the PAYE and NIC which were being evaded.

We would also extend the definition of group. The Companies Act 2006 test would only aggregate companies which are required to produce consolidated accounts because there is a parent company which directly or indirectly holds a majority of their shares. Such a consolidation would not investigate beyond the parent company. It would not follow the shareholders.

Our system would consolidate companies which were managed as a group by virtue of their common ownership and control. For example, where the same individual shareholders controlled a majority of the shares in different companies. This would be a test of fact. Where two companies were controlled by the same individuals then the onus would be on those individuals to demonstrate that there were two completely separate businesses which were not in reality being run as a combined economic unit. We want to focus our tax advantages on the substance, not the form, of a business. There is no merit in drafting detailed rules to govern which companies qualify and which are excluded because that would simply invite taxpayers (and their advisers) to game the system.

Consolidation would also apply on a world-wide basis. If a foreign multinational established a UK subsidiary then, irrespective of the size of the UK presence, all of the multinational group’s assets, turnover and workforce would have to be counted to determine whether the UK subsidiary was eligible for tax exemption. Equally, a UK-headquartered business would have to include its overseas subsidiaries.

Corporation tax applies to both the profits of a company in the conventional sense of a trading surplus and the capital gains it makes. Both would be exempted from tax under the new system. A “prior year” approach like this provides compliance certainty. Next year’s business plan can be drafted in the reasonable knowledge that the company will not be subject to tax. An unexpectedly good performance will not retrospectively levy tax on this year’s earnings.

The date of establishment of the business would be immaterial. By definition, however, a new business will not have a prior year, so no new start-up would be subject to corporation tax.

That would leave a possible loophole in that a company could engineer annual spoof takeovers, placing successive new holding companies on top which could claim to be new start-ups eligible for automatic exemption. Therefore the automatic first-year exemption would not apply in situations where it was obvious that the new business would not be small e.g. because it has raised a sufficiently large amount of capital; it has recruited a large workforce; it is purchasing an existing business which is not "small".

The *quid pro quo* for exemption of all small company profits from taxation is that small company losses could not be carried forward and used to offset future chargeable profits once the company had outgrown the thresholds. "Loss" in this context would include capital losses.

> A company makes a loss of £0.5m in Y1; profits of £0.25m in Y2; and profits of £1m in Y3.
>
> ***Under the current system:***
> In Y1 it pays no corporation tax on its loss.
>
> In Y2 it pays no corporation tax on profits of £0.25m because they are eliminated by the brought-forward Y1 loss of £0.5m.
>
> In Y3 it pays corporation tax on profits of £0.75m because its actual profit of £1m is reduced by the balance of the brought-forward Y1 loss.
>
> ***Under the new system:***
> None of the profits for Years Y2 and Y3 would be taxed anyway if the company was "small".
>
> New companies typically make losses in their early years, which they carry forward as a buffer against paying tax once they become profitable. Start-ups would have two bites at the cherry if they both escape tax on profits earned while they were a small company and also claim the benefit of earlier losses from many years previously once they have become large.

By the same token, qualifying small companies would not be eligible for capital allowances and similar tax-favoured schemes. Eligible capital expenditure could not be carried forward to a time when the company came into the scope of taxation.

The existing rules which tax the extraction of value from companies would carry over. In particular, the rules relating to "close companies" (broadly, those controlled by five or fewer participators) and the provision to levy a tax charge on a close company which made a loan to one of its shareholders or their associates. Measures which were necessary to combat the removal of income from companies which are taxed on their profits would be required even more in a situation where those profits were untaxed.

For the purposes of corporation tax a "company" generally means a body corporate or an unincorporated association but not a partnership, a local authority or local authority association.[55] For certain purposes this is extended to include authorised unit trusts.[56] Partners are subject to income tax on their trading gains. Since they might consider themselves disadvantaged by the Policy, we would allow partners to elect for their firm to be considered as a company for tax purposes (but only for tax purposes). The election would be irrevocable (firms would not be allowed to switch their tax status from time to time as it suited them) and would apply to all of the participants.

Allowing partnerships to "opt-in" could be considered to create opportunities for tax leakage, for example by permitting spouses to rearrange their assets. However those opportunities are already present in the current tax system, and there are anti-avoidance mechanisms for handling them. Since partnerships could incorporate themselves anyway and directly benefit from the Policy, it is simpler to recognise this commercial reality and reduce the administrative inconvenience for all parties. This facility would, of course, apply only to trading partnerships.

It is possible that a small company might cease to qualify for the exemption because the nature of its activities changed over time. For example, a trading company might divert resources into a non-trading side-line such as the acquisition of investment properties and eventually the earnings from this side-line could predominate. Alternatively, a trading company might be the subject of a takeover and become part of a group that was either too big to be eligible, or whose overall earnings failed to satisfy the trading test.

In either case, a "disqualifying event" would have occurred and the company would become liable for corporation tax. However, the prior-approach means that the first profits that would be taxable would be those for the accounting year after the disqualifying event. This will give businesses time to adapt their plans accordingly.

By the same token, it is possible that an investment company could become eligible for exemption by, for example, buying a new trading subsidiary. It would still be liable for corporation tax on the profits of the year in which the acquisition occurs. The company would only attract exemption for the profits of the following accounting year.

[55] Corporation Tax Act 2010 section 1121.

[56] Corporation Tax Act 2010 section 617.

Compliance

Instead of filing a corporation tax return, and paying corporation tax, at the normal due date an exempt small company would file a Nil Return. This would set out the grounds on which exemption was claimed, i.e.:

- The company's turnover (identifying the trade(s) which was its source, and also indicating any non-trading sources)
- The company's total assets
- The company's workforce
- The company's ownership (i.e. identifying its shareholders)
- Confirmation of why the company believed that it was not under common ownership and control in a group which in aggregate exceeded the qualification thresholds
- Confirmation of why the company believed that it was not caught by the IR35 and related provisions
- Confirmation that no disqualifying events had occurred (or, the details of any disqualifying event)

This would not add to the administrative burden of running the company. Its directors would have to know the answers to these questions before they could be certain they were eligible for exemption. The typical small business, in which a handful of individuals own shares in a single company and they do not have outside interests, would have no difficulty in discharging this compliance burden.

Individuals who were shareholders in a number of different companies would have to supply more information in order to claim exemption, but this would still be less of a burden than drawing up a full corporation tax return and paying the tax. In principle the requirement to disclose the ultimate ownership of the company is no more onerous than the existing filing obligations with Companies House, and there are good policy reasons for requiring disclosure in combatting general tax evasion.

A conventional trading company would have no difficulty in meeting the disclosure requirement relating to IR35. The burden would be heaviest for those one-man personal service companies, and those which sourced clients through intermediate brokers, which represent the highest risk of tax avoidance. Such businesses would have to disclose more detail about their work practices to confirm that they were not undertaking disguised employment.

This item is included in the Nil Return precisely in order to force a company which is being used to avoid employment tax to incriminate itself, or at least to highlight to HMRC that a situation warranted further enquiry. An IR35 trader that did not claim exemption by filing a Nil Return would continue to be liable for corporation tax, which would provide some compensatory offset for the employer's and employee's NIC being avoided. (Indeed, failure by a small one-man company to apply for exemption might itself raise suspicions in HMRC.)

Under the current system, although all companies would be subject to a flat tax at 20%, the size of any profits remains significant for the payment deadline.

- If profits are £1,500,000 or less then corporation tax is paid in a single tranche nine months and one day after the end of the accounting period.
- If profits exceed £1,500,000 then the company has to pay in instalments (each instalment being 25% of the expected total amount due, with the opportunity to adjust the amount paid over in the light of business conditions as the year progresses):
    - 1st: three months + 13 days from the start of the accounting period
    - 2nd: three months after the 1st
    - 3rd: three months after the 2nd
    - 4th: three months + 14 days after the end of the accounting period

It is clearly possible for a company to generate profits in excess of £1.5 million and yet remain a "small company" because of the size of its workforce and its balance sheet. We would therefore retain these payment dates as the deadlines for filing a Nil Return by a small company.

HMRC would have all the information they might require in deciding whether to challenge the company's tax exemption. In particular, whether to challenge on the basis of common ownership and control with any other company. They would also be forewarned of disqualifying events.

Transitional provisions

We do not believe that any transitional provisions are necessary.

Businesses already use the small companies regime, because it applies to the annual accounts which they have to file with Companies House. We are not inventing something

new and unfamiliar. In the twelve months before the start of the new system on 1 April 2015 trading companies would know whether they would be eligible for tax exemption (because of the prior year approach on which exemption works) and they could plan accordingly.

Why is this a good idea?

By allowing small companies to retain more of their earnings it will become easier for them to self-finance their own expansion. This dynamic sector of the economy would become less reliant upon credit granted by the banks. This competition should in turn encourage the banks to be more supportive of commercial customers generally, in order to maintain their own positions against a possible loss of custom.

A higher level of investment sustained over the long term would also help in the rebalancing of the UK economy away from debt-fuelled consumer spending.

APPENDIX 4: ABOLITION OF CAPITAL GAINS TAX ON SHARES IN SMALL COMPANIES

How would the Policy work?

With effect from 6 April 2015, no capital gains tax ("CGT") would be charged on individuals or the trustees of settlements when they dispose of shares in companies which qualified as small trading companies when the shares were acquired.

There would be no requirement for the shareholder to be an employee or officer of the company.

There would be no minimum shareholding for exemption to apply.

There would be no minimum holding period for ownership of the shares.

Losses on investments in small trading companies could still be used to offset other chargeable gains. There would be no change to the current tax system on this point. Although there is a symmetry argument for not allowing investors to claim these losses (on the basis that all the upside would be tax-free), it would penalise risk-taking if investors could not receive relief for a bad investment in a small company when they could offset losses in medium/large trading companies and all non-trading companies.

Existing legislation would remain in force. A new enactment would provide that gains would not be chargeable to CGT if they arise from the bona fide commercial disposal of shares in a company which was eligible for exemption from corporation tax as a small company at the time they were acquired. As defined this would only cover genuine exits from continuing trading businesses, or their liquidations, and would exclude artificial transactions designed to release value from a company free of tax which left the shareholders' economic interests unaltered. That would be a question of fact. The exemption would be overridden by existing anti-avoidance provisions intended to catch e.g. the conversion of income into capital.

CGT exemption would be driven by the status of the shares when they were acquired. Subject to later comments, in general the size of the company at the time of disposal would be irrelevant.

The corporation tax exemption discussed in Appendix 3 does not extend to trading companies in the oil and insurance sectors, because they have their own specialist corporate taxation regimes. To maintain symmetry, shares in such entities would not attract the CGT exemption, either. This might be considered to unfairly stigmatise those industries.

Given the size qualifications for eligibility as a small company, it is not considered likely that this would be an issue in practice, and that to permit CGT exemption would invite tax avoidance opportunities. This is a point which could be canvassed as part of any consultation exercise on draft legislation prior to implementation of the Policy.

Existing CGT legislation covers situations where a company undergoes a transaction and the shareholder is left with different shares, often in a different company.[57] The effect of the legislation is to equate the new holding with the old and to defer any CGT charge until the new shares are sold. Taxpayers have to apply to HMRC for clearance of the transaction and confirmation that there will be no disposal charges. Such provisions would remain in force and would carry over the original CGT exemption to any new shares. Taxpayers would simply request confirmation that their CGT-exempt status was retained as part of the pre-existing clearance procedure.

The CGT status of the shares would be determined by the tax status of the company for the year in which the acquisition was made. It would not affect the status of the shares if the company subsequently became liable for corporation tax because it exceeded the three thresholds (asset value/turnover/workforce).

> Example: A Ltd is a small trading company. In Year Y it undertakes a second round of financing by selling shares to new investors.
>
> This extra tranche of capital allows A Ltd to build a new factory and hire extra workers. As a result it ceases to qualify for exemption from corporation tax.
>
> Under the prior year basis for corporation tax exemption, this expansion means that the company would be liable for corporation tax on its profits for Year Y+1 onwards. The company status for Year Y would be unaffected.
>
> In Year Z, A Ltd is sold for £50m in cash. But the new investors would have bought their shares during Year Y, when the company was still exempt from tax, and so their shares would qualify for exemption from CGT on the sale. So would those sold by the original investors.

The position would be different if the disqualifying event related to a change in the nature of the company's business. In that case, the shares would lose CGT exemption, but only for the growth in value after disqualification. The shareholder would be deemed to have made a disposal and immediate reacquisition of the shares for their then market value.

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57 Taxation of Chargeable Gains Act 1992: sections 126-130 (reorganisations or reductions of share capital); sections 132-134 (conversion of securities); sections 135-140 (company reconstructions and amalgamations).

> Example: B Ltd is a small trading company engaged in waste management with a non-trading business investment property portfolio to utilise land not required in the main business. John established the company in Year X with a £1,000 equity investment and he is the 100% shareholder.
>
> In Year Y, at a time when B Ltd as a whole has a market value of £10m, the non-trading activities predominate and so B Ltd is disqualified from corporation tax exemption. This is a change in the nature of the business, so John is deemed to have sold the company and reacquired it for £10m. Because his shares have CGT-exempt status, there would be no tax to pay at that time.
>
> In Year Z, John sells the whole of B Ltd for £25m. This disposal is within CGT, but his chargeable gain is only £15m, not £25m, since that is the gain he has made since the time B Ltd became a non-trading company.

The converse situation would be a non-trading company which becomes exempt from corporation tax because of a change in the nature of its business. The default rule would be that this had no effect on the status of the shares, which would remain caught by the CGT net. However it would be possible for the shareholders to elect to bring themselves within the exemption. This election would also have the effect of deeming them to have sold and reacquired the shares for their then market value. That would give rise to a CGT liability at the time of conversion, but this can be seen as a form of "entry fee" to receive future CGT-exempt status for their shares.

> Example: C Ltd is a small investment property company which runs a waste management trade from land not required in the main business. John established the company in Year X with a £1,000 equity investment and he is the 100% shareholder.
>
> In Year Y, at a time when C Ltd as a whole has a market value of £10m, the trading activities predominate and so C Ltd is now qualified for corporation tax exemption. John elects to have this treated as a change in the nature of the business. John is deemed to have sold the company and reacquired it for £10m. Because his shares are within CGT, he has a gain of £9.999m (£10m notional sale proceeds less £1,000 base cost). John pays CGT at 28% through Self Assessment, a liability of just under £2.8m.
>
> In Year Z, John sells the whole of C Ltd for £25m. He has made a gain of £15m on this disposal (£25m sale proceeds less £10m notional base cost) but this is exempt from CGT.

> If John had not elected to qualify his shares in Year Y, on the sale in Year Z he would have made a chargeable gain of £24.999 m (£25m sale proceeds less £1,000 original base cost). Under Self Assessment at 28% that would have been a liability of just under £7m.

Where a medium or large trading company becomes eligible for corporation tax exemption because it falls below the three thresholds, there would not be an opportunity for shareholders to bring their shares within CGT exemption. This maintains symmetry with the fact that there is no loss of exemption when a small company grows in value. It also protects the tax base against the ability of shareholders to manipulate the size of the company to engineer CGT advantages for themselves (e.g. by temporarily laying off staff to come below the workforce threshold). The new system is intended to reward people who take a risk by investing in small trading companies, not to provide windfalls for other categories of investor.

There would be no change to any of the anti-avoidance measures which recategorise certain capital transactions as income for tax purposes e.g. the rules which govern transactions in securities used to manufacture income tax advantages,[58] or when certain share buy-backs are treated as dividends.[59] The purpose of the new system is to reduce the tax burden on capital, not to change the boundary between capital and income. To the extent that the tax burden on capital is abolished, it would become even more important to catch transactions designed to disguise income.

The current tax system contains a number of measures designed to provide relief and exemption from CGT for shares. They would be abolished under the new system. After 5 April 2015 it would not be possible to claim income tax relief for new investments under the Enterprise Investment Scheme (EIS),[60] the Seed Enterprise Investment Scheme (SEIS)[61] or in Venture Capital Trusts (VCTs)[62]. Nor would it be possible to register new companies under these schemes after that date.

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[58] Income Tax Act 2007 Part 13 Chapter 1 (sections 682-713).

[59] General rule: Corporation Tax Act 2010 section 1000. Exemption for certain unlisted trading companies: Corporation Tax Act 2010 sections 1033-1043.

[60] Income tax relief: legislation now contained in Income Tax Act 2007 Part 5 (sections 156-257). CGT treatment: Taxation of Chargeable Gains Act 1992 sections 150A-150D and Schedule 5B.

[61] Income tax relief: Income Tax Act 2007 Part 5A (sections 257A-257HJ). CGT treatment: Taxation of Chargeable Gains Act 1992 sections 150E-150G and Schedule 5BB.

[62] Income tax relief: legislation now contained in Income Tax Act 2007 Part 6 (sections 258-332). CGT treatment: Taxation of Chargeable Gains Act sections 151A-B and Schedule 5C.

Entrepreneur's Relief[63] creates a lower CGT rate on some gains made on the sale of shares in certain trading companies. This would not apply to disposals of shares made after 5 April 2015. However, the relief applies more widely to business assets held by personal traders, and it would continue for those situations.

Share Loss Relief[64] allows individuals to claim income tax relief for losses made on the disposal of shares in certain companies (now either EIS companies or independent companies engaged in trades which would qualify for EIS) below a certain size threshold. In the absence of this provision individuals could only claim relief for such losses by setting them off against other chargeable gains. There is a limit on the maximum relief which may be claimed each year (and which varies from year to year). The aim is to provide an incentive to invest. We believe that the justification for this relief is diminished by the introduction of the Policy. Share Loss Relief would be abolished for individuals.

The new system would make no change to tax-favoured savings vehicles such as ISAs.

The Policy would apply only to capital gains made by individuals and trusts. Gains made by companies are taxed in a different way (although a lot of the same rules apply) through the corporation tax system. Capital gains made by small companies would be covered by the exemption from corporation tax.

Corporate investors would still be eligible for the company equivalent of Share Loss Relief. More significantly, the "substantial shareholding exemption"[65] would remain in force. In broad terms this exempts from tax:

- A trading company or the parent company of a trading group (and for these purposes, "trade" includes a wider range of activities than would be caught by the conventional definition we would use in the Policy);
- Which sells a "substantial shareholding" (a holding of at least 10% but in practice 20%) that has been held for at least 12 months;
- The shareholding is in a trading company.

We consider that there is no pressing need to amend the position of corporate investors under the current system.

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63 Taxation of Chargeable Gains Act 1992 sections 169H-169S.

64 Legislation now contained in Income Tax Act 2007 Part 4 Chapter 6 (sections 131-151). There are equivalent provisions for companies in Corporation Tax Act 2010 Part 4 Chapter 5 (sections 68-90).

65 Taxation of Chargeable Gains Act 1992 Schedule 7AC.

Compliance

CGT is collected through Self Assessment. A taxpayer would include an Exemption Claim in his tax return for the year of the disposal specifying:

- The company involved
- When the acquisition was made
- The proceeds of sale
- The original cost

HMRC would be able to cross-check these details against their records of the Nil Returns filed by the company. That would enable them to identify companies which had ceased to be exempt from corporation tax in the past and thus situations where disqualifying events might have led to a loss of CGT exemption.

The taxpayer could also voluntarily file notice of such a disqualifying event as part of their Self Assessment return for the tax year in which it occurs. They could include their estimate of the market value of the shares involved. This provides an opportunity to negotiate an agreed new base cost at the time rather than waiting until an eventual disposal.

Taxpayers who wanted to opt-in to CGT exemption (e.g. an investment company whose business changed so that it became a trading company) would have to declare the deemed CGT liability that arises on conversion as part of their Self Assessment return for the tax year in which it occurs.

Transitional provisions

The new CGT regime is designed to encourage more investment in small trading companies. Shares in existence on 6 April 2015 would represent investment that has already taken place, and so it could be argued that it is not necessary to provide them with any further advantages. A simple and pragmatic response would be to confine the new system to shares bought after 5 April 2015.

However, maintaining two parallel capital gains rates applying to shares acquired either before or after April 2015 would not simplify the tax system. Furthermore, if all pre-April 2015 shares were to remain within the CGT net then it would simply invite taxpayers to engineer spurious “bed-and-breakfast” arrangements whereby they sold and reacquired their shares.

In the past new CGT regimes have applied to *disposals* made after the start date. A judgment of Solomon is therefore required for handling different categories of shares in issue when the new system commences.

Existing tax-privileged schemes

Shares acquired under the EIS, SEIS and VCT schemes before 6 April 2015 would be "grandfathered" i.e. they would continue to receive the privileges of those schemes, but they would have to continue under the original conditions. So, for example, a holder of EIS shares would be exempt from CGT on disposal but they would have to have held the shares for a minimum period of three years. Any event which would have been a breach of the scheme rules leading to a withdrawal of the tax privileges would continue to have the same consequences. It would be straightforward to ring-fence such investments because, under their original rules, there were not meant to be any dealings in the shares anyway.

This might be thought to make EIS/SEIS/VCT investments less attractive during 2014/15 and cause investors to delay acquisitions until after 5 April 2015 when they could claim full CGT exemption under the new system. However the new system does not include upfront income tax relief for acquisitions, or deferral relief for other capital gains, so there is still some benefit in making a scheme investment in 2014/15. The fact that these other advantages are available to participants is the justification for holding them to the rules of the scheme. Investors could make non-scheme investments in 2014/15 and opt-in to claim CGT exemption for them once the new system had come into force.

There is no requirement for transitional provisions regarding the abolition of Share Loss Relief. The relief may only be claimed for either or both of the tax year in which the loss arises or the previous year. Losses arising after 2014/15 would be handled under the CGT system alone.

Existing shares in companies which qualify as small trading companies on 6 April 2015

From the moment that the new system starts those companies will be filing Nil Returns with HMRC and there will be a paper trail which justifies CGT exemption for investors in those companies. All such shares would be regarded as automatically eligible for CGT exemption.

In theory it is possible that a company could have moved in and out of eligibility in the period between the original investment and the start of the new corporation tax regime. There is no merit in pursuing this point. These companies are precisely the type we wish to encourage with the new system.

Existing shares in companies which would have been eligible in the past but are no longer eligible on 6 April 2015

These investments would not be eligible for CGT exemption under the new system.

If the new system had been in force when the original investment was made, investors would have gained tax advantages because at that time the company would have been a small trading business. But the company is not eligible now, either because it has grown in size, or because it has ceased to be a trading company. These are not the categories of business which the Policy is designed to assist. There would be administrative difficulties in deciding how far back in time the test would be applied, and only a small fraction of all companies would benefit.[66]

Why is this a good idea?

The abolition of corporation tax would make it possible for owner-managers to retain earnings within the company and so self-finance expansion. But this reform by itself will not make it any easier for the business to acquire the seed capital it requires to actually start.

There are three main routes which the current CGT system uses to encourage equity investment:

- Capital gains are taxed at a lower rate than income. Basic rate taxpayers who would pay 20% on their general income would be charged at only 18% on their capital gains, and those who pay 40% or 45% income tax would be charged at 28%.
- Entrepreneur's Relief[67] further operates to reduce the CGT rate on gains made from trading companies to 10% (irrespective of the income tax rate of the entrepreneur).
- Tax-privileged schemes (EIS,[68] SEIS,[69] VCTs[70] and arguably Share Loss Relief[71])

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66 According to Companies House statistics, at most 8% of UK companies – and in practice much less since that figure would include listed companies, hardly any of whose present owners would have acquired their shares at a time when the entity was a small company.

67 Taxation of Chargeable Gains Act 1992 sections 169H-169S.

68 Income tax relief: legislation now contained in Income Tax Act 2007 Part 5 (sections 156-257). CGT treatment: Taxation of Chargeable Gains Act 1992 sections 150A-150D and Schedule 5B.

69 Income tax relief: Income Tax Act 2007 Part 5A (sections 257A-257HJ). CGT treatment: Taxation of Chargeable Gains Act 1992 sections 150E-150G and Schedule 5BB.

seek to stimulate new investment by offering income tax relief, CGT relief and CGT exemption on sale.

Our criticism of this regime is not that it is misconceived, but that it lacks ambition. It does not go far enough to foster a genuine enterprise culture.

- The difference between the tax rates on income and capital do not give sufficient recognition of the risk taken by entrepreneurs in small trading companies when they defer immediate income.

  How do EIS, SEIS and VCTs reward individuals who invest in small, high-risk trading companies? By allowing them 100% exemption from CGT. If that is the appropriate tax benchmark, why is that approach not followed for all such investment?

- The usefulness of Entrepreneur's Relief for encouraging risk capital in small companies is undermined by its restrictive provisions.[72]

  It only extends to shares in companies/groups which do not have a "substantial extent" of non-trading activities.[73] HMRC have indicated in guidance this means no more than 20%. So it would not cover all businesses with a mixture of trading and non-trading activities, even if the trading activities represented a clear majority.

  To attract relief the gains have to be made on a disposal of shares in a "personal company"[74], i.e. the individual has been an officer or employee of a company in the same group,[75] and has held at least 5% of the issued capital, for twelve

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[70] Income tax relief: legislation now contained in Income Tax Act 2007 Part 6 (sections 258-332). CGT treatment: Taxation of Chargeable Gains Act sections 151A-B and Schedule 5C.

[71] Legislation now contained in Income Tax Act 2007 Part 4 Chapter 6 (sections 131-151). There are equivalent provisions for companies in Corporation Tax Act 2010 Part 4 Chapter 5 (sections 68-90).

[72] The relief is not confined to shares, but would also apply to disposals of personal business assets by sole traders and the members of partnerships. However this paper is concerned only with its company aspects.

[73] Taxation of Chargeable Gains Act 1992 section 165A.

[74] Taxation of Chargeable Gains Act 1992 section 169S.

[75] Somewhat perversely, although it is a requirement that the investor be an officer or employee, there are no requirements as to service or remuneration. So a 5% investor who

months prior to the sale. For disposals after 5 April 2013, if this test is not satisfied, shares can still be eligible if they were acquired under a special tax-favoured employee incentive known as an Enterprise Management Investment Scheme share option ("EMI").[76] The relief therefore discriminates against outsiders – and it also confines the relief to a maximum of 20 people. Hard luck for companies that want to encourage wider employee ownership.

The gains which can be taxed at the favourable 10% rate are subject to a lifetime limit for each entrepreneur, currently £10 million. Once an individual has realised gains in excess of the limit, during the whole course of his working life, then he will pay CGT at the full 28% rate irrespective of the type of company or whether he is personally involved in it from day to day. That quite obviously penalises serial entrepreneurs – who are the likeliest source of seed capital for new businesses.

Although it was only introduced in 2008, the rules of Entrepreneur's Relief have been amended repeatedly. The lifetime limit has been raised from £1 million (6 April 2008) to £2 million (6 April 2010) to £5 million (23 June 2010) to, currently, £10 million (1 April 2011).

- The tax-privileged investment schemes are confined to companies or groups which do not undertake excluded trades to a "substantial extent" (again, HMRC have indicated this means 20%). There is a blacklist of activities which are excluded, which has now been standardised across all the schemes.

  It is not obvious what makes these activities so obnoxious – why, say, coal mining should be excluded but uranium mining is acceptable, or why ship building is ineligible while ship repairing is not. Confining eligibility to "approved" trades reduces the number of businesses which can benefit. By discriminating between sectors, the schemes potentially constitute illegal State Aid under the EU Treaties. The result is that HMRC have to comply with EU monitoring of the schemes and

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was appointed as an unpaid director, but never attended any meetings, would be taxed at 10% on a sale, while an employee working full-time and holding 4.9% could be taxed at 28%. The provisions practically amount to an invitation to companies to pack their boards with spoof directors.

[76] The provisions for which are now contained in Income Tax (Earnings and Pensions) Act 2003 Schedule 5. In outline, companies are only eligible to grant an EMI option if they are engaged in a qualifying trade (which means, that they are not engaged in a black-listed trade, similar to the provisions for EIS etc.), if they have fewer than 250 employees and if their asset value does not exceed £30 million.

the UK Government cannot alter the legislation without prior permission from the Commission.

To minimise the cost to the Exchequer (and to avoid State Aid problems) there are limitations on (a) the amount each individual can invest; (b) the size of the shareholding they can acquire; (c) the amount each company can raise; and (d) the ability of the shareholder to sell. In contrast with Entrepreneur's Relief, investors are prohibited from being employed by the company (although they can be paid non-executive directors). Thus, serial entrepreneurs cannot use the sale of a previous business to finance the start of another one unless they decide not to work full-time for it.

Hardly a year goes by without a Finance Act that tinkers with the rules for these schemes, whether by tweaking the definition of the blacklisted activities or altering some of the limits and other eligibility criteria. If EIS and VCTs were working well, why was it necessary to launch SEIS in 2012?

It would better realise the policy objectives behind the current CGT system if there was CGT exemption on sale for shares in small trading companies, with no black-list of activities; no minimum holding period; no limit on the values which can be invested in the company or raised by it; neither a minimum nor a maximum size for the shareholding to attract exemption; and neither a requirement nor a prohibition on the investor being employed by the business.

If individuals were free to invest in any small trading company on whatever commercial terms were appropriate, it would not be necessary to bribe them with upfront income tax relief to make them favour some trades rather than others. If there is no CGT on investment gains from small companies then it will be unnecessary to bribe people to reinvest gains in new companies to gain CGT deferral relief.

Most of the restrictions placed on EIS/SEIS companies are designed to prevent the "abuse" of an investor enjoying the benefit of capital, on which income tax relief or CGT relief has been given, before the end of the minimum holding period. But if the system does not contain income tax or CGT deferral relief, and there is no minimum holding period, then conditions for clawing back the relief are unnecessary. It is perverse to prevent an investor working in a new company if he wants to. One of the most valuable things an entrepreneur can invest in a new business is the human capital of his experience.

APPENDIX 5: REFORM OF UK DIVIDEND TAXATION

How would the Policy work?

With effect from 6 April 2015 dividend income received by UK individuals from UK companies would be treated as part of general income and taxed as such. The tax credit on franked dividends would be increased.

Dividend income would cease to be a special category subject to its own special income tax rates.

- "Franked dividends" paid by medium/large companies (which would be subject to corporation tax on their profits) would carry a new, higher tax credit of ¼ of the payment received.
- "Unfranked dividends" paid by small companies (which would not have paid corporation tax on their profits) would not carry a tax credit.

There would be no change to the rules on dividends paid by overseas companies to UK taxpayers.

The current tax rules for inter-company dividends, i.e. those paid by one company to another, would remain unchanged.

There would be no change to the existing rules which characterise certain transactions as taxable distributions (e.g. dividends). In circumstances in which some companies will not be paying tax on their profits, it will clearly be necessary to ensure that all income and quasi-income extracted from companies remains within the tax net.

The new system would not apply to property income distributions ('PIDs') paid by real estate investment trusts ('REITs'). At present the REIT is obliged to deduct tax at 20% from the payment.[77] The shareholder declares the payment as property income and receives credit for the tax withheld. PIDs are not taxed as dividend income and that would continue under the Policy.

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[77] The Real Estate Investment Trusts (Assessment and Recovery of Tax) Regulations 2006 (SI 2006/2867)

Compliance

This would affect individuals who have to file Self Assessment tax returns for 2015/16 and onwards. The deadlines for doing so would be 31 October 2016, for individuals who want to submit a paper tax return, and 31 January 2017, for those who want to file their return on-line.

Individuals already have to declare the amount of dividends they have received, the associated tax credits, and the combined gross dividends (i.e. these two amounts added together). The only difference is that some dividends would now be unfranked and not carry a tax credit. HMRC would amend the standard tax return to include a new set of boxes to distinguish the two types of dividend to make reporting easier for taxpayers.

Because dividends would now be included in general income, and not be a separate category, it would greatly simplify the working sheets which taxpayers use to calculate their tax liability when submitting a paper tax return.

Companies would be responsible for informing their shareholders of whether their dividends are franked or unfranked. This will not create any difficulties.

- Listed companies already inform their shareholders of the amount of tax credit attaching to the payment. All that would happen is that the rate of this tax credit would alter (and the overwhelming majority of listed company dividends will be franked because the paying companies will not be eligible for corporation tax exemption). We know from past experience that companies are able to adapt to changes in the tax credit rate quite easily.
- The typical unlisted company will involve the managers paying dividends to either themselves or to professional venture capitalists. Both of these groups can be expected to already know whether their company is paying corporation tax or not. Neither should have any difficulty in understanding the consequences for the payments they have received.

Transitional provisions

There would be no need for transitional measures.

Companies would simply issue slightly different information to shareholders when paying dividends after 5 April 2015, and taxpayers would have a slightly different Self Assessment return to complete.

Why is this a good idea?

The separate taxation of dividends dates from 1999/2000 and is an indirect consequence of Gordon Brown's raid on the pension funds. Previously, dividends had been subject to advance corporation tax (ACT) at 25%, which in turn entitled the

receivers of dividends to a tax credit equal to ¼ of the payment. That credit could be reclaimed by taxpayers and was of considerable benefit to institutions such as pension funds which did not pay tax.

To compensate the funds who had lost out, and to minimise the cost to the Exchequer, Brown introduced a transitional measure based around a lower tax credit of $^{1}/_{9}$th. As a follow-on consequence dividends had to be treated as a separate category of income subject to their own special rates of tax, to avoid penalising individuals. The net effect was the same for individuals (basic rate taxpayers had no net liability, and higher-rate taxpayers paid 25% net on the dividend received) but this was achieved by multiplying the number of rates charged by the tax system as a not-very-effective means of camouflaging a stealth tax on pension funds. There is no good policy reason for continuing to tolerate this unnecessary complexity.

There is also an argument for change based on fairness. If corporation tax is abolished for small companies, but their shareholders remain entitled to a 10% tax credit on dividends then:

- Medium and large companies would be subject to double taxation: first on the underlying profits generated by the company (corporation tax) and secondly in the hands of the shareholders in the form of dividends (income tax)
- Small company shareholders would receive a tax credit, and hence suffer a lower overall tax liability, when the Exchequer had not received any corresponding tax revenue.

This would distort the yields on investment in medium/large companies as compared to those in small companies, and could open a loophole for abuse by shareholders. The most effective means of maintaining fairness, and ensuring that no shareholder is put in a different position to the one they have under the present (more complicated) tax system, is to increase the tax credit to 20% but to confine it to franked dividends.

This may be demonstrated by an example. A notional £100 generated in a company can be followed through to its end recipient. We will assume that this occurs after April 2015, so that the corporation tax rates are standardised at 20% for all companies under the current system. Under our reformed system of dividend taxation:

- The individual taxpayer ends up with the same net dividend in cash terms as they would under the current system *irrespective of whether they are a basic rate, a higher rate or an additional rate taxpayer*. No one is worse off, and there is no opportunity to game the system.

- There is the same level of efficiency in extracting value from the underlying company *irrespective of whether it is a tax-exempt small company or a taxable medium/large company*. No company is being either prejudiced or advantaged by this part of the tax system. The decision over whether to pay a dividend, and what size that dividend should be, remains purely commercial and is not being driven by tax considerations.

People receiving unfranked dividends from small companies suffer a higher headline rate of tax than people receiving franked dividends from medium/large companies. But small companies will not have paid corporation tax before the dividend reaches the individual. These people end up paying the rate of tax applicable to their income band. There is therefore no income tax advantage in extracting value from a small company by way of dividends (although there would be NIC differences).

APPENDIX 5: REFORM OF UK DIVIDEND TAXATION

	Current System	Under the Policy	
	All companies All dividends	Small company Unfranked dividends	Medium/large Franked dividends
Underlying earnings	£100	£100	£100
Corporation tax rate	20%	Nil	20%
Corporation tax	(£20)	Nil	(£20)
Dividend paid	£80	£100	£80
Tax credit rate	$^1/_9$	Nil	¼
Tax credit	£9	Nil	£20
Gross dividend	£89	£100	£100
Basic Rate Taxpayer:			
(a) Tax liability	(£9)	(£20)	(£20)
(b) Tax due	Nil	(£20)	Nil
(c) Net dividend	£80	£80	£80
(d) Effective tax rate	Nil	20%	Nil
(e) Efficiency	80%	80%	80%
Higher Rate Taxpayer:			
(a) Tax liability	(£29)	(£40)	(£40)
(b) Tax due	(£20)	(£40)	(£20)
(c) Net dividend	£60	£60	£60
(d) Effective tax rate	25%	40%	25%
(e) Efficiency	60%	60%	60%
Additional Rate Taxpayer:			
1) Tax Liability	(£33)	(£45)	(£45)
2) Tax Due	(£25)	(£45)	(£25)
3) Net dividend	£55	£55	£55
4) Effective tax rate	31¼%	45%	31¼%
5) Efficiency	55%	55%	55%

Here "Effective tax rate" means how much of the actual dividend paid to the individual is lost to tax (i.e. after having already been taxed or not in the company), and "Efficiency" means how much of the original underlying earnings is passed to the shareholder.

APPENDIX 6: ANTI-AVOIDANCE

The Policy creates potential opportunities for tax leakage but existing tax law is sufficiently robust to prevent abuse.

How would fraudulent claims of small company status be blocked?
The directors of a small company are already trusted to certify that they are within the small companies accounting regime. The Policy would simply extend this to cover an additional certification that this meant they had no corporation tax to pay.

To fraudulently claim to be a small company, the directors would have to under-declare some or all of the turnover, the asset value or the workforce when filing a Nil Return.

- The company would remain within VAT, which is a turnover tax. Businesses have to register if their turnover of taxable supplies exceeds £81,000 over a twelve month period.[78] The existing VAT enforcement regime would therefore act as a check.

  A trading company would only fall outside the VAT net if it were engaged in non-taxable supplies, i.e. VAT exempt goods and services, or if most of its supplies were zero-rated and it applied to HMRC for permission not to register. These would be a minority of businesses operating in defined sectors and HMRC would be able to adopt special procedures for monitoring them. The Nil Return would indicate the sources of the company's turnover.

- The company would remain within PAYE for paying its workforce. There is an existing PAYE enforcement regime which would act as a check.

  To evade detection the business would either have to (a) divide itself among several different companies and claim that they were not all under common ownership and control; (b) attempt to conceal employees by purporting to re-hire them as independent self-employed contractors; or (c) pay some but not all of its employees in cash outside PAYE.

  The case of (a) is considered later in this Appendix. As regards (b) and (c), these are already long-standing problems in the existing tax system. There are existing enforcement measures for catching such cases. The Policy does not create any additional difficulties.

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78 Value Added Tax Act 1994 section 3 and Schedules 1-3A. The amount of the threshold is set by periodic statutory instrument, the current one being The Value Added Tax (Increase of Registration Limits) Order 2014 (SI 2014/713) with effect from 1 April 2014.

- There may be scope to undervalue the assets of the business, particularly if the company were also exempt from outside audit. However this would only be successful if the directors could also succeed in undercounting one of the other two factors and evade detection.

What would block a business being spread between multiple companies?
The accounting rules for qualification as a small company apply to a consolidated group, so the business could not escape liability by splitting its operations between several subsidiaries.

More problematic is the question of a franchised business. As an alternative to owning subsidiaries, from which dividends could be drawn, a company might licence other businesses to operate in return for annual fees. This would leave the "parent" company in the same economic position as ownership but the licensees would be able to claim to be independent small companies. Here the case would turn on the precise facts of the franchise arrangement and the degree to which the licensees were under the direct control of the "parent" in the absence of its ownership (and thus the extent to which they were genuinely carrying on a trade on their own account). Most franchises, however, would probably pass this test.

If Company A and Company B were engaged in the same trade, had the same directors and were owned by the same people in the same proportions, it would be extremely difficult to argue that they were not under common ownership and control. To evade liability, the shareholders would have to own different proportions of Company A and Company B and there would have to be non-identical boards of directors. Their defence would still be weak if the same individuals held between them a majority of the shares in the two companies and the same directors comprised a majority on both boards. They would have to involve outsiders in order to dilute their control. That makes the scheme less attractive to the insiders. Beyond a certain point, there would be a genuine question whether these businesses were a single entity or not.

For example, suppose a family company has shareholders from different generations and branches. To resolve a genuine commercial disagreement, a demerger separates it into two companies each running a separate trade and managed by different cousins, but owned in the same proportions by the same relatives (to simplify the CGT position). Are they now one group or two?

The solution is to judge each case by its own facts, rather than attempting to draft precise rules which will only invite companies and their advisers to attempt to evade them.

APPENDIX 6: ANTI-AVOIDANCE

What would prevent self-employed individuals turning themselves into companies?
Gordon Brown experimented with very low tax bands for companies. There was a 10% starting rate for 2000/1 and 2001/2, which was lowered to 0% in 2002/3. HM Treasury were clearly taken by surprise by the number of businesses which turned themselves into companies. Eventually, in the Pre-Budget Report of 5 December 2005, Brown gave up the attempt to defeat "tax-motivated incorporation".[79] The 0% starting rate was abolished from 2006/7.

The policy failed not because it opened the floodgates to tax avoidance but because it applied to such a small level of profit (£10,000) that the economy received no meaningful benefit from exemption, and at the same time Brown did not carry through other necessary changes. The 0% starting rate was merely an ill-thought out gimmick.

Under the current system a self-employed trader would be subject to income tax at 20%/40%/45%, and a flat rate of Class 2 NIC plus a variable rate of Class 4 NIC on the profits. If that business were incorporated as a small trading company it would pay 0% tax on the same profits. But the individual is now a shareholder-employee of the new company. There are two ways in which they could reward themselves with the untaxed company profits:

- If the employee-shareholder pays the profits to himself as salary, then he will be liable on that salary for income tax at 20%/40%/45% and Class 1 employers' and Class 1 employees' NIC. The rates on NIC on employment earnings are higher than those on self-employment. Furthermore, the tax and NIC would have to be paid over monthly through the PAYE system rather than in twice-yearly payments on account through Self Assessment.

  So, if the owner-manager pays all of his profits to himself as salary, the Exchequer ends up better off than if he had remained self-employed.

- If the employee-shareholder pays the profits to himself as dividends on his shares, the dividends will be unfranked and he will be liable on the full amount without a tax credit for income tax at 20%/40%/45%.

  There would be a saving for the owner-manager from this route because dividends are not subject to NIC. For 2014/15, the Class 4 rates are 9% on annual profit over £7,956 and below £41,865 and 2% on profits above the upper threshold. Admittedly,

[79] "Many self-employed and employed people are being advised to incorporate simply to reduce their tax and NICs liability." (Pre Budget Report 2005 para 5.92).

that is a saving which looks worth having – but it is a saving which could be made by incorporating a business under the current system. The Policy does not increase the opportunity for NIC avoidance.

Correspondingly, however, under the Policy an exempt small company would no longer be eligible for capital and other allowances, which previously would have effectively cost the Exchequer untaxed profits at 20%/40%/45% if claimed by a trading individual. So the Exchequer would also make a compensating saving which reduces the true revenue loss.

As employees of the new company, the business owners would have to pay themselves some salary, otherwise they would be in breach of the minimum wage legislation. That would bring them within the anti-avoidance provisions of the Income Tax (Earnings and Pensions) Act 2003 which catch the various mechanisms for extracting remuneration. HMRC have proved extremely willing over the years to use these provisions to attack creative employers. On balance, the only way that a newly incorporating business could save itself a material amount of tax is to retain profits within the company and use them to expand. That, of course, is the objective behind the Policy.

Introducing corporation tax exemption for small businesses will indeed encourage a greater level of incorporation by the self-employed. In turn that will lead to a corresponding fall in the level of income tax receipts from the self-employed (although there will be a compensating increase in the income tax on dividends). We have built this assumption into our modelling. Our conclusion is that the loss in immediate revenue is more than made up by the wider gains from a more vibrant small business sector. We do not believe that this constitutes a flaw in the Policy.

What would prevent employees turning themselves into companies?

This problem is already present under the current tax system. The “IR35” anti-avoidance measure was introduced by Gordon Brown in Budget 1999 to counter it. Those provisions remain on the statute book and have been extended.[80]

The essence of these measures is to identify individuals who are in substance employees but have disguised this through the legal form of an intermediate company or using a third-party broker to arrange work. The effect is to levy an additional tax charge which collects the balance of the amount the individual would have paid as an employee.

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80 The initial Brown anti-avoidance measure is now Income Tax (Earnings and Pensions) Act 2003 Part 2 Chapter 8 (sections 48-61). Alistair Darling added Income Tax (Earnings and Pensions) Act 2003 Part 2 Chapter 9 (sections 61A-61J) in 2007.

We believe that this problem is already blocked by the current tax system. There have been many criticisms of the IR35 measures. They have been accused variously of being too draconian, of being too vague and uncertain, of being inappropriate for a sector such as IT and even of being ineffective and failing to have raised the anticipated revenue. But the underlying principle is surely sound: that people discharging the substance of employment should be taxed as such and not allowed to camouflage the relationship under a different form. The correct response to the criticisms of IR35 is not to reject the Policy, but to improve IR35.

What would stop individuals converting income into capital?
If the shareholders of a company leave profits inside the business to finance its expansion, then they will have converted income into capital by creating a company which is more valuable. However, we would not regard this as tax avoidance. It is the objective of tax policy to encourage people to do exactly this sort of thing. It is entirely right that they should receive favourable CGT treatment when they exit from the business on a sale of their shares.

Critics might claim that entrepreneurs would deliberately leave value inside a company in order to sell it later. There is no way of distinguishing such “bad” behaviour from the “virtuous” conduct of reinvesting profits in order to build up a business. Whose money is it? And if entrepreneurs deny themselves the immediate enjoyment of their profits, they are surely entitled to preferential tax treatment.

Under the current tax regime, Entrepreneurs relief already reduces CGT on share sales from 28% to 10%. Abolishing CGT for small companies altogether is likely to contribute to a positive culture change which will greatly outweigh “bad” behaviour.

Legislation already contains a panoply of measures to block “artificial” planning which is intended to disguise income receipts as capital. These would remain in force to penalise individuals who attempt to enjoy a revenue gain at a favourable tax rate.

The dividing line, then, would be whether shareholders are making a genuine exit, i.e. scaling down their economic interest in a business and realising value (which merits favourable tax treatment), or whether they are drawing revenue from a continuing business in which their economic interest is essentially unchanged. This distinction is best tested with an example which lies exactly on the line.

Jimmy is a popular entertainer. He establishes JimCo1. He undertakes a series of one-off engagements for a variety of clients (TV companies, cruise liners etc.). The contracts are all made with JimCo1. Jimmy’s services would not qualify him as an employee of the

end-clients, so IR35 never becomes relevant. He takes a small salary, and perhaps some dividends, from JimCo1 as the sole director-shareholder but most of the company's earnings are invested in a portfolio of traded securities. JimCo1 reinvests the income from the portfolio in further acquisitions. As soon as the fees paid to JimCo1 plus the investment income reach £6.5 million, Jimmy takes a holiday for the remainder of the tax year.

JimCo1 would appear to be a qualifying small company because it seems to be engaged in a trade (exploiting Jimmy's talents as an entertainer) and although the investments mean it will have a large asset value, it has only one employee (Jimmy) and its turnover never exceeds the threshold. After a suitable interval of time, Jimmy makes himself redundant, collecting a P45 on the way. He then sells JimCo1 and establishes JimCo2. He repeats the same conduct with JimCo2, selling it in due course and moving on to JimCo3. On the relevant Self Assessment tax returns, Jimmy will claim CGT exemption for the sale of each company.

The immediate question is: do we regard this as an abuse? The answer is: probably, yes. Why? Not because of the way in which Jimmy has run his business. In general, the strategy of building up a business through the substantial retention of earnings, with a view to an exit through an eventual sale, is perfectly respectable, and even to be encouraged. No, the abusive conduct which Jimmy has undertaken is that the real trading business involved is the exploitation of his talents as an entertainer, and he has not exited from that. JimCo1 is simply an investment shell. Jimmy has not built up and disposed of a trading business in any meaningful sense. Therefore he should not take advantage of a special treatment which applies to exits from a trading business (CGT at 0%) and should instead have the advantage of the special treatment which applies to exits from non-trading businesses (CGT at 18%/28% rather than income tax at 40%/45%).

However it does not follow that Jimmy would obtain CGT exemption under the Policy. For the reasons given, Jimmy's conduct does not amount to a *bona fide* commercial disposal in the sense of the exemption. HMRC could resist allowing Jimmy relief on those grounds. This position would be strengthened to the extent that Jimmy's transaction was taxable under other provisions.

There are a number of lines of attack which HMRC could pursue under existing legislation.

- What is being sold? JimCo1 is a mere shell which holds some investments. No trade undertaking is changing hands. Jimmy could only claim CGT exemption if JimCo1 had ever been a genuine trading company.

The test is one of fact, and of substance over form. HMRC could argue that as a matter of fact the intention had been to establish JimCo1 as a shell to be sold at some point in the future (a claim which would be strengthened if there were later sales of JimCo2 and JimCo3 and the argument was about whether those sales were CGT exempt). That would mean that JimCo1 had never been a real trading company, and so never eligible for corporation tax exemption. HMRC could therefore assess JimCo1 (in practice, the new owners) for unpaid corporation tax in respect of previous years, and assess Jimmy for CGT on the sale of his shares.

How would HMRC ever find out? JimCo1 will have an asset value representing the underlying investments of, say, £V. But no outsider would ever pay £V to acquire a portfolio worth £V when they could buy it in the open market for the same amount. They would only be interested in the transaction if they could buy the portfolio at a discount (and if the portfolio does not constitute investments available on the open market, then the outsiders would still want to buy at a discount to reflect this lack of marketability). The buyers are also exposed to the risk of having to pay tax on JimCo1's previous "trading" profits, which further reduces the value to them of the portfolio.

On the other hand, Jimmy has a company which is worth £V on paper, but if JimCo1 ever distributed that value to him then he would have to pay income tax on it at, say, 45%. The real value of JimCo1 to Jimmy is much less than £V. So long as he can sell the company for at least 55% of £V he is still better off through a sale than from simply taking dividends – but he will also need a margin to cover the possibility of having to pay CGT. There will be a degree of haggling and the final price will end up somewhere around 75% of £V.

When Jimmy files his Exemption Claim for the sale of JimCo1, HMRC will be able to match up the Nil Returns filed by JimCo1 and notice that an apparently successful company is being sold at a considerable discount. That would alert them.

- Alternatively, HMRC might decide to attack Jimmy's status as an employee of JimCo1 using the Income Tax (Earnings and Pensions) Act 2003. They could argue that the investment portfolio represents a deferred bonus pool connected to Jimmy's employment and that the outside purchasers were intermediaries being used to deliver it to him. That would bring the sale proceeds into income tax and NIC and short-circuit CGT altogether.

  The applicability of the employment anti-avoidance provisions is somewhat

tenuous on these facts, but HMRC has had success in the courts at using them to overturn the apparent legal form of transactions. In November 2011 the Court of Appeal decided *PA Consulting v HMRC* in their favour. That was a rather complex scheme involving a bonus pool being diverted through an offshore entity and special classes of share, but the judgment did uphold the general principle that HMRC can overturn the legal form, even if the end-benefit which the employee receives is already subject to income tax.

- A third option which HMRC could pursue, particularly by the time they were processing an Exemption Claim from Jimmy in respect of JimCo3, is to look at his conduct as a whole. They could allege that Jimmy has two occupations: (1) as an entertainer working for the JimCos; (2) as a promoter and seller of investment companies. As such, since HMRC would argue it had always been Jimmy's intention to sell the companies he had established, the sale proceeds would be personal trading income subject to tax at 20%/40%/45% plus NIC.

  The likelihood of success of this third line of attack is confused by the fact that some precedents pre-date CGT (when gains on the sale of assets would only have been taxable if they resulted from an "adventure in the way of trade"). The most favourable case for HMRC would be *Leach v Pogson (1962).* Someone who successively established and sold 30 driving schools was held to have been running a trade from the outset because on the facts it had always been his intention to sell each business once it was established.

  On the other hand *Salt v Chamberlain (1979)* was decided after the introduction of CGT. A mathematician decided to try his hand at forecasting share prices and undertook 200 transactions over a 5 year period. He was not successful and tried to claim relief for his trading losses. The court held that the prima facie presumption is that individuals speculating in securities are investing, not trading. It is only a trade if an individual conducts his activities in the same way that registered share traders do (regular clients; risk management; established office; whether trading on a market or buying and selling as a customer of the market etc.)

  This third line of attack is probably the weakest for HMRC. When the case got to court it would probably turn on how blatant Jimmy had been in trying to realise tax-free money.

- Finally, HMRC could always use the new General Anti-Abuse Rule (GAAR)[81] which came into effect on 17 July 2013. This is aimed at blocking "abusive tax arrangements", i.e. where it would be reasonable to conclude that obtaining a tax advantage was the purpose of the arrangements, and the arrangements cannot be regarded as a reasonable course of action in regard to the relevant tax provisions.[82] The GAAR is meant to be a last resort measure and it has the effect of counteracting any purported tax advantage by making just and reasonable adjustments.[83]

  The clear purpose of the corporation tax and CGT exemptions of the Policy are to help businessmen to establish and expand small trading companies. They are not meant to facilitate the sale of investment portfolios. On that basis, HMRC would probably succeed in claiming that Jimmy was being abusive. The obvious just and reasonable adjustment is to treat JimCo1 as never having been a trading company: Jimmy would have to pay CGT on the sale, and the new owners would have to settle unpaid corporation tax (for which they would presumably then sue Jimmy).

Value could be extracted from a company other than by sale. For example, the company could be liquidated. These cases would still be "disposals" for CGT purposes, and the same principles would apply: the shareholders would only enjoy CGT exemption if they were making a genuine exit from a genuine trading company. So, shareholders could establish and then liquidate a series of small companies without paying CGT, withdrawing some of the proceeds every time. If they were establishing and then liquidating investment shells, they would not be able to claim CGT exemption. If they were establishing genuine trading ventures, are they doing anything wrong?

The example of Jimmy can be contrasted with the case of a serial entrepreneur. Someone who invests in a small trading company clearly does so with a view to selling the shares in the future at a gain. Someone who does this repeatedly with different companies is clearly speculating, in the sense of paying to take a risk. But they are not trading and they are not extracting hidden income from the companies. In each case they are injecting capital into a business, allowing that business to grow, and then exiting, having taken a return and passing on a continuing trading business to new

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[81] Finance Act 2013 Part 5 sections 206-215.

[82] Finance Act 2013 section 207.

[83] Finance Act 2013 section 209.

owners. If at any stage the entrepreneur invested in a non-trading company, then the gain would be subject to CGT.

The example of Jimmy can also be contrasted with an owner-manager. A shareholder who works in the business and makes a gain when it is sold is not receiving a form of employment bonus. (There might be circumstances in which he acquired the shares as a benefit of his employment, but that would have been dealt with through the income tax system at the time.) That is unaffected even if he continues to work for the new owners after the takeover. In fact, the conclusion is strengthened. The former owner's economic interest in the business has clearly altered, but equally he is still being paid for his services as an employee. That is fairly decisive proof that there is a distinction between the reward he receives for his services and for his invested capital.

The Policy is sufficiently robust to counter abuse. Those situations where individuals would enjoy untaxed capital gains would not represent the avoidance of tax. They are the objective of the Policy.

What would stop foreign companies exporting profits abroad free of tax?
Eligibility for corporation tax exemption is based on a world-wide aggregation of assets/turnover/workforce with other companies under the same common ownership and control. A foreign multinational establishing a UK subsidiary in order to earn profits free of tax would be caught by this test. If the group as a whole exceeded the UK thresholds then the UK subsidiary would be required to account to HMRC for corporation tax like any medium/large UK company.

If a foreign business was still able to qualify then its UK subsidiary would not pay corporation tax. That would still leave the foreign parent in the same position as any other overseas company in receipt of UK source dividends and within the scope of any applicable tax treaty. The onus of proof would remain on the foreign parent.

The increase in the tax credit on franked dividends could give rise to an extra cost for the Exchequer where those credits are refundable to foreign shareholders under an applicable double tax treaty. The outcome would depend on the precise arrangements in force between the UK and each overseas country. This could be regarded as a weakness with the Policy. Alternatively, it could be regarded as an incentive for increased foreign direct investment in the UK and justifiable on the same policy grounds as the present right for foreign shareholders to reclaim tax credits. We are not able to quantify this exposure. Out of 128 tax treaties entered into by the UK with other countries, 23 would confer an entitlement to a UK tax credit in 2015/16 on dividends received by an

overseas shareholder.[84] A further three treaties entitle foreign companies which hold at least 10% of a UK company to a credit equal to half that of a UK shareholder.[85]

In theory shareholders in the relevant countries could reclaim part of the UK tax credit from HMRC, unless they also operated a permanent business establishment in the UK (in which case the dividends would be taxed as part of the business earnings). In practice, however, under the current tax system the issue rarely arises. The tax treaties also permit the UK to tax the gross dividends, generally at 15% following OECD guidelines. As the current tax credit is only 1/9th of the dividend, the UK is able to charge more tax than the credit, leaving nothing for the overseas shareholder to reclaim. There is only a small outflow of cash (approx. 27p for every £100 of dividends) in respect of countries where a 10% investor company provision applies, because in those cases the treaty limits the UK tax rate to 5%.

This position would change under the Policy. A franked dividend of £100 from a medium/large company received by a UK shareholder would now carry a tax credit of £20. If the gross dividend were taxed at 15% then an ordinary overseas shareholder could reclaim £2 from HMRC. A 10% investor company in a relevant country could reclaim £4.50, but if the holding was in a small company they would not be entitled to anything at all because the dividends would be unfranked.

We do not consider that the Policy would create a material tax leakage. Any greater outflow from HMRC would be more than compensated for by an increase in foreign direct investment as the UK becomes a more attractive location for overseas businesses, or additional stamp duty receipts from overseas investors purchasing shares in UK companies. The repayable tax credit for overseas shareholders is something of a historical relic found only in older tax treaties. The practice of the UK Government has been to delete it when negotiating updated agreements with foreign states. We would expect that approach to continue.

Summary

We consider that the existing state of tax law and practice is sufficient to close down the major avenues through which the Policy could be exploited for tax avoidance purposes, or at least it does not create any new problems that are not already present. Where

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84 Treaties with: Belize; Bosnia-Hercegovina, Croatia, Montenegro and Serbia (all four covered jointly by the original treaty with Yugoslavia, which remains in force with them as successor states); Brunei; Cyprus; Fiji; Gambia; Iceland; Indonesia; Jamaica; Kenya; Kiribati; Malawi; Malta; Philippines; Romania; Solomon Islands; Spain; Sudan (which would also apply to South Sudan as a new state); Thailand; Trinidad & Tobago; Tuvalu; Zambia; and Zimbabwe.

85 Treaties with: Italy; Luxembourg; and Sweden.

apparent leakages of tax occur, they do not constitute serious failings in the Policy but actually represent justifiable features necessary to help the Policy to achieve its aim.

Nevertheless, we would not expect a development in the UK tax system as innovative as this Policy to be implemented without an appropriate period of prior consultation on the draft legislation. Most obviously this would commence in the autumn of 2014 with a view to an announcement of the conclusions in the 2015 Budget and their enactment in the first Finance Act of the new parliament. The issue of protecting the tax base against abuse is one of the matters which such a consultation would naturally involve. It would be unusual, to say the least, for a Finance Act to introduce a new tax exemption without accompanying it with a raft of new anti-avoidance measures.

APPENDIX 7: TIMING ADVANTAGES

Tax/spending for Year Y	Timing of the cost	Timing of the gain
Corporation tax	Small companies: 9 months after the end of their accounting year i.e. during Year Y+1 or Y+2	Larger companies: Quarterly during or slightly after their accounting year i.e. mainly during Year Y
PAYE	None	Monthly during Year Y
Employee's NIC	None	Monthly during Year Y
Employer's NIC	None	Monthly during Year Y
Self-Assessment income tax	Self-employed who convert to company status: 31 January in following tax year i.e. during Year Y+1 (There might be a downward-adjustment to payments on account for subsequent years, but that would depend on the level of dividends paid to the business owner)	Anyone in receipt of small company dividends: 31 January in following tax year i.e. during Year Y+1 (There might be an upward-adjustment to payments on account for subsequent years, but that would depend on the level of dividends paid to the business owner)
Self-employed NIC	Self-employed who convert to company status: 31 January in following tax year i.e. during Year Y+1	None
VAT	None	Quarterly during Year Y, with some falling into Year Y+1
Capital Gains Tax	Under self-assessment:31 January in following tax year i.e. during Year Y+1	To the extent reinvested savings leads to greater taxable gains, these would be many years hence.
Other taxes	None	Mainly during Year Y.
DWP savings	None	During Year Y to the extent that the number of unemployment claimants fell, or there were reduced claims arising out of low earning households.

APPENDIX 8: CARTELIZATION

Category	Top 5 companies market share
Search Engines	99%[86]
Smartphone Operating Systems	99%[87]
Video Game Software	91%[88]
Radio	90%[89]
Fixed-line telephony	92%[90]
Airline industry	89%[91]
Banking	85%[92]
Cinema screens	80%[93]
Gas	76%[94]
Supermarkets	70%[95]
Electricity	65%[96]

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86 http://lollipoplocal.co.uk/what-happened-to-bing-local-uk-here-prime-places

87 http://www.kantarworldpanel.com/smartphone-os-market-share/

88 http://www.psu.com/forums/showthread.php/309619-UK-Retail-Marketshare-1Q-2013

89 http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr11/UK_Doc_Section_3.pdf

90 http://point-topic.com/services/uk-plus/

91 http://www.caa.co.uk/default.aspx?catid=80&pagetype=88&sglid=1&fld=2013Annual

92 http://www.bbc.co.uk/news/uk-politics-25764261

93 http://stakeholders.ofcom.org.uk/binaries/consultations/market_invest_paytv/annexes/annex11.pdf

94 http://www.academia.edu/555316/UK_Energy_Market_Overview

95 http://uk.kantar.com/consumer/

96 http://www.academia.edu/555316/UK_Energy_Market_Overview

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