

## **Small Company Taxation in the UK:**

### **A review in the aftermath of the ‘Arctic Systems’ Ruling**

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#### **Summary**

This paper analyses the way in which the owners of many small limited companies reward themselves and members of their families out of the income that their labour generates for those companies. This is particularly relevant in the light of the recent House of Lords ruling in what is known as the ‘Arctic Systems’ case. The paper shows that many of these arrangements do constitute tax avoidance because the rewards paid do not much the underlying economic substance of the transactions that are taking place.

In the interests of promoting tax justice for all taxpayers HM Revenue & Customs have a consequent duty to promote new arrangements that will encourage tax compliant behaviour in this sector. Tax compliance is defined as paying the right amount of tax (but no more) in the right place at the right time where ‘right’ means that the economic substance of the transaction accords with the declaration made for taxation purposes.

The paper does then show that this problem is almost insoluble whilst these businesses are operated through the medium of small limited companies which were not designed for and are unsuitable for the type of activity they undertake.

As a result this paper proposes that:

1. A change in company law to allow the re-registration of small limited companies as LLPs. An LLP is tax transparent: its income is taxed as if it belongs to its members even though it is a legal entity that is separate from them for contractual purposes;
2. The introduction of new capital requirements for the incorporation of limited companies undertaking trades, and over time forced re-registration of those that do not meet that standard as LLPs;
3. The introduction of a new investment income surcharge at rates broadly equivalent to national insurance charges that would have the benefit of reducing the incentive to split income, restore the taxation balance between income earned from all sources and allow a reduction in the base rate of income tax without adding substantially to the burden of administration for taxpayers since those liable will, in the vast majority of cases, already be submitting tax returns;
4. Create new, economically justifiable and verifiable standards for splitting income in LLPs so that the risk of legal challenge to such arrangements will be substantially reduced whilst recognising the significant role that the partners of those who supply their services through owner managed corporate entities play in the undertaking of that activity.

If this were done then:

- a. The administrative burdens for many small businesses would be reduced;
- b. The certainty of the arrangements under which they can operate would be increased;
- c. The rewards that they rightly seek to pay to those who contribute to the management of these companies from within domestic relationships will be rewarded, but within appropriate constraints;
- d. The attraction of freelance status in tax terms would be retained;
- e. The current injustice that sees income from labour more heavily taxed in the UK than income from capital would be eliminated in

large part without prejudicing the required favoured status of pensioners;

- f. The incentives for tax planning would be reduced, so simplifying tax administration;
- g. The tax yield might either rise, or a reduction in the tax rate might result.

The challenge in creating such a system is significant because it requires cooperation across government departments, but far from insurmountable. It is part of the challenge of creating an enterprise culture that meets the needs of the UK in the 21<sup>st</sup> century, and that is a challenge that any government needs to meet.

## Background

The debate on the taxation of small companies has always generated considerable heat. The ruling by the House of Lords in case of *Jones v Garnett* in July 2007, (otherwise known as the ‘Arctic Systems’ case after the name of the limited company to which it related) has only added to the intensity of that debate. This has in turn been fuelled by announcement of the government’s intention to legislate to achieve the result that they failed to secure through the Courts using existing legislation in this case. Given that the government has also announced that this process will involve consultation this seems an opportune moment to explore the issues of concern to them, and to explore ways to resolve those issues which do not pose a significant burden upon the economic effectiveness of small companies in the UK.

## The economics of the Government’s claim

The first thing that is required is an economic analysis of the logic inherent in the government’s claims. Since this appears to have been little understood, such an analysis should add a rationale to discussion which does, on occasion appear to be missing. What follows is a model of small business taxation through the medium of a limited company from an economic perspective. To simplify the presentation most of the analysis is undertaken using diagrams, but some assumptions and acronyms will need to be defined at the outset.

First, it is assumed that a limited company owned by two people is being considered. They are called Husband (H) and Wife (W). They need not be legally related, but I'm assuming they do not have a third party relationship either.

It is also assume that this business does not have all the hallmarks of a trade that are easily identified e.g. significant capital investment in stock, fixed assets or working capital. It may or may not have business premises: they might be in the family home. It supplies services, not goods. Costs incurred in proportion to the value of services supplied would, if the company operated at near capacity, be low. Profit margins are high and marginal income over a relatively modest level can largely be equated almost directly to funds available for distribution to the members in some form or other, what the form should be being the core focus of this paper.

The contributions made to the limited company by H and W to generate the income it earns (it being assumed that it cannot generate profit of its own freewill, about which I think there will be relatively little dispute, interest on cash deposits aside in this case) are:

1. Capital. This is the money subscribed for the shares H and W own in the company. We'll call it C and the part paid in by the husband will be HC and the wife WC. It also includes the retained profit of the company, but given its low capital requirements this is likely to be minimal and does not distort the analysis offered here.
2. Effort. This is hours expended in pursuit of the income generated by the company. It is labour contribution for which the economic reward is a wage or salary. We'll call this S. That attributable to the husband is HS and that to the wife WS.
3. Enterprise. This is the inspiration that gives the company the competitive edge in the market in which it operates. This is, of course, related to human endeavour but is of a different form. It is about management foresight. It can come as a flash of inspiration and might represent a better charging model, a better delivery mechanism, the choice of a good name or logo, or an appropriate management structure, for example. It can, of course, require effort expended over time and this is hard to differentiate from the Effort of the type noted above. It is however the return for business acumen: it is the activity that generates a return above the normal for labour time expended. Conversely it is also that process which can

result in the benefit of labour effort being lost through it being misdirected. We'll call this E and that due to the husband is HE and that to the wife is WE.

Combining these gives rise to the following diagram:

**Diagram 1**

<b>HE</b>	<b>WE</b>
<b>HS</b>	<b>WS</b>
<b>HC</b>	<b>WC</b>

The area of the diagram represents the net income pre tax, salaries to H and W, and dividends but after all other costs (with their associated tax cost if disallowable for taxation purposes) available for distribution to the two participants in the company. This is not, of course, fixed.

### **Relating the economics to the structure of a limited company**

There are only two effective ways at present to pay these rewards as a result of the combination of company and taxation law. The first is by way of salary, which is appropriate for the payment of HS and WS. Dividends are the closest distribution available in law for the payment of HE, WE, HC and WC. Unfortunately, there is no way of differentiating them. Interest cannot usually be paid on capital in a small company.

In practice HC and WC often closely equate to interest. This is also, in no small part, what the dividends paid by quoted companies approximate to. The analogy is not perfect, but the movements in stock markets based upon changes in interest rates clearly suggest the association. The association is good enough for the current purpose. In that case the return in the vast majority of companies of the type being considered would be tiny. That is

because even having allowed for the risk inherent in small companies inflating the required interest rate to a level well in excess of that which is commonly quoted in the money markets the actual absolute amount of the payment made would remain small: these companies tend to have very small capital sums invested in them precisely because they have limited use for that money. Total sums invested of only £1,000 or so are commonplace in this sector. Even if interest rates of 20% were charged this would still make the combined total of HC and WC just £200. In almost all cases that will be immaterial to the distribution of reward from the company.

However it can be argued that HE and WE can also only be properly paid through dividends on share capital in an enterprise of this sort. But as the House of Lords and previous rulings in the Arctic Systems case have noted, such returns may vary from year to year. With ordinary share capital usually being fixed, varying dividends on different classes of shares being frowned upon by tax authorities, and the transfer of shares between husbands and wives to achieve this result also being likely to result in considerable questioning from tax authorities if undertaken regularly (and potentially involving other costs) once the share capital of the company has been subscribed for, very often before trading by the limited company has commenced, the ratio in which HE and WE can be paid has been set, whether it is right or wrong.

### **The reality of small business economics**

It is unlikely that the labour input of the husband and wife will be similar in many small companies. It is also unlikely that their entrepreneurial input will be similar. It is uncommon for companies of the type under consideration here to be partnerships of equals: the trade that the company undertakes usually reflects the professional skill of one of the parties to which the other offers support. As such a possible diagram reflecting the economic rewards due to the two parties might be as follows:

### **Diagram 2**

<b>HE</b>		<b>WE</b>
<b>HS</b>		<b>WS</b>
<b>HC</b>	<b>WC</b>	

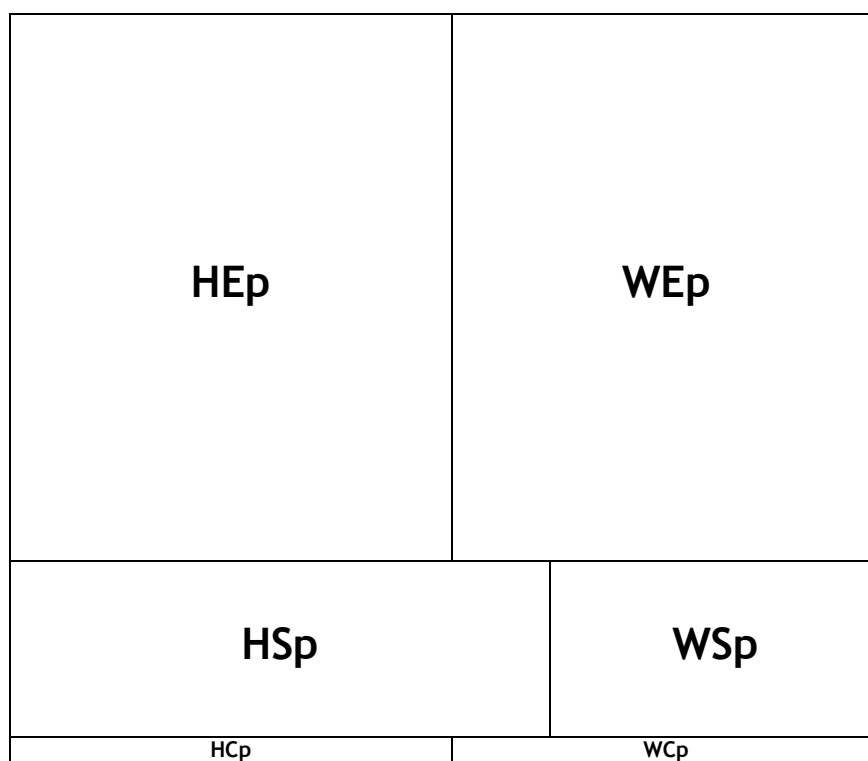
The terms W and H could be, and often are, reversed.

The point this diagram makes are this:

1. The returns to labour, enterprise and capital are unlikely to be equal;
2. There is no reason why the ratio of contribution of effort made by the two partners need be equal;
3. There is no reason why the ratio of return due to enterprise and capital need be the same even though dividends are the only reasonable means available for paying that return which arises over and above the reasonable rate due for the labour expended by the share owning participants in the company.

This seems obvious. The problem that arises is that under current law it would despite this be entirely possible to distribute the rewards shown in Diagram 2 earned in the way shown in the following diagram:

### Diagram 3



The overall dimension of the diagrams is meant to be identical, even if word processing produces a slightly different result.

In this diagram the letter 'p' has been added to each term to indicate a payment made in the form described rather than the sum earned. So, and for example, HSp is the payment made in the form of remuneration for labour services supplied by the husband, which contrasts with HS which is the value of the economic sum actually attributable to that person resulting from their expenditure of effort in that way.

### A measure of the problem

It is apparent that in this case, the following holds true by comparing diagrams 2 and 3, which relate to the same entity:

$$(HCp + HSp + HEp) < (HC + HS + HE)$$

In other words, the total paid to the husband for taxation purposes is less than the total sum that he has earned when assessed economically. It follows that the wife in this partnership is being paid more than she has actually economically earned. This arrangement is, for taxation purposes, called income splitting.



It is also true that in this case both the following hold true:

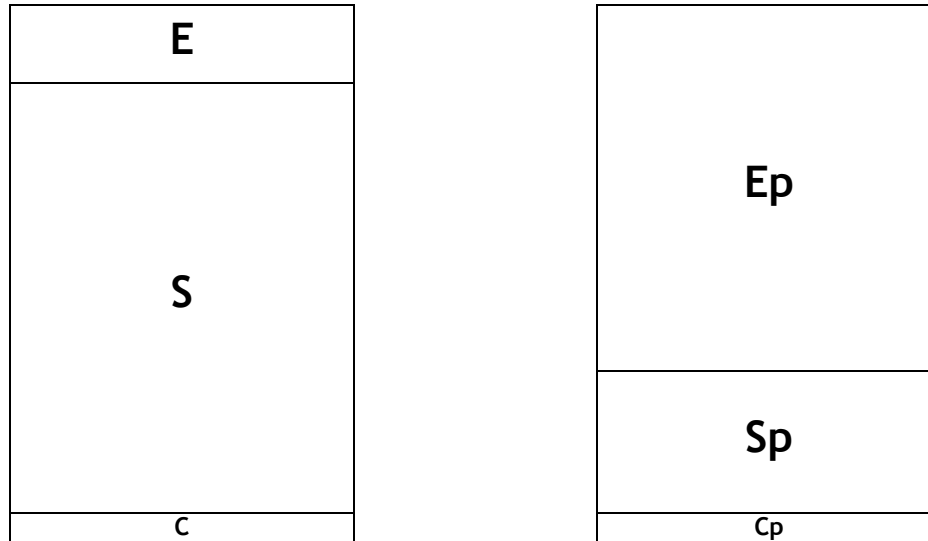
$$(HC_p + HE_p) > (HC + HE)$$

$$(WC_p + WE_p) > (WC + WE)$$

Or to put this another way, the amount paid as dividends to the husband and wife are both greater than can be justified by the underlying economic activity. This is generally called salary substitution in taxation terms.

It should also be noted that there is also an abuse of the underlying economics by way of salary substitution even if the company has just one shareholder (as is legal) and that shareholder also generates the entire income of the company if the split between the returns to enterprise and capital in the form of dividends is inappropriately high compared to the underlying reward generated from the expenditure of labour effort. This is shown as follows (there being no need in this case for the terms H or W):

**Diagram 4**



In this case the fact that:

$$E_p > E$$

and

$$S > S_p$$

Both are clear signs that an artificial tax driven arrangement is in place. And that is true. If tax compliance is defined as paying the right amount of tax (but no more) in the right place at the right time where 'right' means that the economic substance of the transaction accords with the declaration made for taxation purposes then it is clear in this case that tax compliance is not occurring: tax avoidance is instead. In that case there is a need for action to curtail this situation on the part of the government.

### Why this is important

It is stressed that none of these things would be important if:

1. Dividends and salaries were taxed in the same way and at the same tax rate in the UK;
2. All income was only taxed at one rate and the level of personal allowance was negligible;
3. There was no national insurance system;
4. Persons living in stable co-habiting relationships were taxed as a single family unit;
5. The government was indifferent to some in society being able to attribute the income they have earned to others who have not generated that economic well being without this opportunity being available to all taxpayers.

None of these conditions hold true in the UK economy:

- a. Dividends can be taxed at a lower rate than equivalent income (20% as compared to 22% at present, for example for those not subject to higher rate tax);
- b. The UK does have higher rate taxation with the intent of creating a progressive taxation contribution as income rises;
- c. National insurance contributions can be as high as tax paid when the employer's contribution is taken into account for a majority of employees in the UK, but there is no national insurance charge on dividend income;

- d. We have separate taxation (for most purposes) of those living in stable relationships, whether legally associated or not;
- e. The government does not approve of the diversion of income to those who have not earned it for taxation purposes, as a matter of policy.

It is important to stress that some of these are unlikely to be the subject of reconsideration as a part of this debate and as such are considered constraints in this discussion. In particular:

1. Progressive taxation is at the core of any just taxation system, matching the need of society with the ability to pay to meet that need. In addition, progressive taxation accords with all accepted principles of economic theory. As income rises the marginal utility of each pound of income falls. As a result a proper progressive tax system will mean that the effective marginal utility cost of tax paid is constant even though the proportion of each part of additional income earned might rise, at least until a certain level of income is reached when a plateau is likely.
2. Pragmatically a national insurance system broadens the tax base and is an effective means of funding pension obligations. Without abolishing state pension obligations an alternative is unlikely. Integration with tax is also unlikely for a number of reasons including resulting difficulties that would arise with the taxation of those of pensionable age who are not liable to make such contributions. None the less policy implications do arise from this which are mentioned later.
3. The operation of self assessment and PAYE is heavily dependent upon separate taxation (subject to constraints created by the tax credit system). In addition, taxing the family unit would give rise to as many problems as it might solve, especially if linked to marriage. Since marriage is more prevalent amongst those with higher income and family unit taxation would only be introduced if it reduced their tax bill such a move would only increase the gap between rich and poor in the UK, a gap that is already threatening social harmony.
4. It would be inappropriate for the government to allow those in self employment or quasi self employment (as the owners of private limited companies are) to divert their income to their partners as compensation for those person's contribution to household

management when the same option was not available to those in employment. Such a policy would be without any logical foundation: there is no reason to suggest that the burden of domestic responsibility is per se greater for the non-self employed partner when one of the couple is self employed than it need be in any other relationship. It is stressed though that nothing in this paper says that the partner who owns part of the self employed business but is not its driving force should not be compensated for the role they play in it: that would be quite unjust. It must be possible that they be paid, but only for the value they generate. There is however no credible argument for changing taxation policy so that they can be paid for non-business activity that they undertake with the overall consequence of reducing the taxation burden of the family unit in the circumstance that one partner was self employed, but no other.

### **Remaining parameters subject to consideration**

This then leaves a situation where the number of parameters capable of alteration to resolve this issue has been markedly reduced. They come down to the following:

1. Changing the taxes that impact directly on this issue;
2. Changing tax rates;
3. Changing the way in which rewards may be distributed by a company;
4. Imposing rules on the allocation of profits within companies;
5. Changing the rules of incorporation.

Anything else has too broad an implication on the rest of the tax system to be considered viable given the scale of the issue being addressed.

### **The scale of the issue**

The scale of this issue also needs to be considered. No one really knows how many companies are “income splitting” or paying dividends in excess of those justified by the return due to enterprise. What is clear is that there are savings by doing so. To illustrate this a number of tax calculations have been prepared using rates and bands for the tax year 2007-08 assuming a

consistent £50,000 of income available for the payment of reward to a single person supplying their services in a number of situations. These are:

1. A salary is paid direct to the person undertaking the work at a total cost of £50,000. This is an actual salary of £44,915 a year having allowed for employer's national insurance. The net salary available after employer's NIC of £5,085, employee's NIC of £3,361 and tax of £9,380 is £32,174 per annum. Total tax due is therefore £17,827.
2. As an alternative the person provides their services through a company. A salary of £6,000 is paid by that company. The company would wish to pay this to a director / shareholder to ensure that national insurance is paid on their account to preserve state pension and other rights. The resulting employer's national insurance cost is £102, the employees NIC cost is £88 and the income tax due would be £77.

Having used £6,102 of profit in this way the rest will be available for company purposes. Part will be used for admin costs of running a limited company structure. This is assumed to total £1,400 per annum. This leaves £42,498 of profit to tax, which at 20% will give a liability of £8,500.

It is assumed that all the profit is distributed to the shareholder. In that case an additional personal tax liability of £1,589 will be due on that sum.

Having taken all these factors into account the total tax due will be £10,356. The net retained earnings would in this scenario be £38,244.

3. A Limited Liability Partnership arrangement is an alternative. This effectively subjects the income to tax as if the participant were self employed whilst still offering the protection of limited liability. It is assumed costs of administration costs will be lower in this case at £1,200 per annum. This leaves taxable profit of £48,800. This gives rise to a tax liability of £13,557 in total made up of:
  - a. Income tax, £10,934;
  - b. Class 4 NIC of £2,509;
  - c. Class 2 NIC of £114.

The net income would be £35,243.

In summary, therefore, the tax due and net benefit received under each arrangement will be (using the assumptions noted as to utilisation of the £50,000 start sum):

	Tax due	Net benefit received
Salaried employee	£17,827	£32,174
Limited company	£10,356	£38,244
LLP	£13,557	£35,243

Income of £50,000 per person may be a little high on average for companies involved in this activity, but was of the approximate level enjoyed by each participant in the case of Jones v Garnett. The savings would be higher if income splitting had been allowed for in the above calculations rather than considering just one person.

The lowest estimate I have seen of the number of companies using income splitting arrangements is 30,000. I think a figure of at least 200,000 much more likely if the option of the individual using a salary substitution arrangement of this sort to split income inappropriately is also considered. That might be a tax loss of £6,000 per company or £1,200 million per annum. That is a not insignificant sum, and justifies action to correct the unfair advantage being supplied to these people; unfairness in this case resulting from the form of the tax charge not aligning with the economic substance or reality that is occurring in the limited company that is being taxed.

### Objectives for change

Within these constraints there remain considerable options for change. It is, however, assumed that in pursuing that change the following objectives are to be fulfilled:

1. The practice of income splitting must be ended as far as possible;
2. The benefit derived from salary substitution must be removed as far as possible;

3. The achievement of these goals must not unduly increase the administrative burdens on business or HM Revenue & Customs;
4. It must remain attractive in tax terms to take the risk of creating a small business.

### The fundamental obstacle

This range of objectives, when matched with the noted constraints appears to make this a difficult issue to resolve. On reflection there is, however, an obvious reason for this. It is that the limited company to which the current tax rules are applied is really not suited for the task it is being used for. This is because:

1. As noted above, the rewards to capital and enterprise must be paid together. Given that it is difficult to alter the ratio of shareholdings from year to year and that varying dividend rates (or dividend waivers, which achieve the same result) are considered inappropriate by HM Revenue & Customs, being indicative in their eyes of potential artificial tax planning (as they have often been) this capital structure is clearly inappropriate for use in a system where the possibility of paying differing reward levels in different years is required, as indicated by the judgements in the Arctic Systems case.
2. The concept of the limited company was created in the 19<sup>th</sup> century and assumed a division between the ownership and control of the company. That division does not exist in the companies under consideration. As such much of the regulation surrounding these entities is wholly inappropriate.
3. It is assumed that the employees of a limited company are distinct from the source of the companies capital, and both are distinct from its management. This is reflected in tax law, where for example charges arise on the use by an employee of the equipment owned by a company when that equipment is in fact paid for in the companies under consideration out of capital most likely provided by the person actually using it as an employee, and therefore paying a tax charge for the benefit of making use of equipment they have funded. There is very limited economic logic to this: on this occasion netting off is the correct economic, accounting and taxation treatment. It is apparent though that the rules of the limited company and its taxation, which create a significant taxation border around the entity

at which a charge must be paid whenever it is crossed do not reflect economic reality in this case.

Other issues could be noted but these are sufficient to illustrate the point.

### Reasons for incorporation

The reasons for using this inappropriate vehicle must therefore be noted. In doing so it should be borne in mind that the number of limited companies in the UK (now approximately 2.4 million based on latest Companies House data) has more than doubled over the last twenty years. Over 90% of these are classified as 'small'. This however does not mean all fall into the area of concern in this paper: most however will be owned by just one or two people, and in the majority of cases these people will probably be related meaning that some of the issues raised here might apply in the majority of these cases.

That said, it should also be noted that it remains the case that a substantial majority of small businesses are not run through limited companies. The number of small businesses can only be estimated since some do not declare their existence but based on recent discussions with HM Revenue & Customs a figure of around 4 million such enterprises might be estimated. Approximately half of those make tax declarations that they have a turnover (i.e. total sales) of less than £15,000 per annum.

This sets the context for deciding to use such an entity, the reasons for which are:

1. To secure guaranteed self employed status. Since it has become commonplace for HM Revenue & Customs to challenge the self employed status of many consultants their 'employers' have required that those persons provide their services through the medium of a limited company to ensure that there is a third party injected into the transaction that thereby separates the two and reduces the risk to the 'employer' of accounting for PAYE taxes that might otherwise be due. The existence of what are known as the IR35 laws provided additional incentive for 'employers' to require this by forcing the PAYE risk onto the contractor's limited company.
2. To secure tax advantages. As noted above, an individual artificially splitting gross income into a low salary and excessive dividend can



secure a tax advantage over both an employed person and a self-employed person seeking to utilise the same gross income to provide themselves with a net reward. This benefit is increased if part of the income is diverted from a person with a higher rate tax bill to a person with a standard rate tax liability, as income splitting between dual owners of companies usually achieves.

3. To secure limited liability. This is oft stated, but in practice of little apparent value to most limited companies. That this is so is indicated by the fact that over 95% of all limited companies that are removed from the Register of Companies are struck off and are not liquidated: they do not have liabilities that the owner required protection from at the end of the corporation's life. However, this does not deny that there is an 'insurance' based rationale for using a limited company to secure protection from some insolvency risk. The fact that this risk is rarely avoided in the case of any borrowing does, however, also suggest that the protection is limited.
4. To secure an environment in which a partnership can be managed whilst allowing the property of each participant to be identified. This is important: when two people work together they wish for some protection from each other (whether or not they are related, marriages do fail and the stress of working together may increase that likelihood for some couples). A limited company provides a proven structure that gives this protection and identifiable and separate interests in the activity without the cost of creating a partnership deed, which may be many times the cost of incorporating a company.
5. To secure prestige. Some people believe that there is more status for themselves or their business if it is run as a limited company. The reason appears to be the illusion of substance that it provides. There is some logic to this. If half of all self employed people have turnover of less than £15,000, as their tax returns would imply, then having a company might suggest an operation more substantial than a typical small business.
6. Because accountants recommend the use of limited companies to their clients. This is an important, but little commented upon phenomenon. The annual accounting charges for running a limited company are probably twice those of assisting a client to run a business as a sole trader. The difference comprises charges for:

- a. Preparing accounts in statutory format;
- b. Preparing corporate as well as personal tax returns;
- c. Company secretarial services;
- d. Dividend planning services;
- e. PAYE services and preparation of declarations such as form P11D for benefits in kind;
- f. Auditing (if undertaken).

Accountants are self interested. The possibility that they recommend a trading medium that suits their purpose at least as much as it suits the needs of their client cannot be discounted.

Any alternative arrangement for the taxation of those seeking to run small businesses must also meet these needs.

### Seeking solutions

It is unsurprising given this range of constraints and vested interests that debate on this issue is heated, and consequently not always constructive. As one commentator said following the House of Lords ruling on the Arctic Systems case “Given that this extraordinary case has baffled every court which has had the task of attempting to dissect it, the House of Lords have reached the only conclusion that is workable.”<sup>1</sup> This paper does not share that view. The Courts might have reached the only solution that was tenable within existing law: this paper assumes the law can be changed.

To be effective though any change in the law has to seek to positively promote the role of small business, fair taxation, reduced administrative burdens of enterprise and good management practice on the part of all participants in this process. This requires a solution that recognises the following:

1. There is a need for a corporate entity for smaller businesses that allows them to operate with a separate legal identity from that of their owners;
2. Within reason (i.e. in the absence of abuse) this entity should enjoy limited liability, as has now become customary;

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<sup>1</sup> Nichola Ross Martin at <http://www.accountingweb.co.uk/cgi-bin/item.cgi?id=171041&d=1032&h=1019&f=1026&dateformat=%25o%20%25B%20%25Y/> accessed 6-8-07

3. That entity should be able to pay rewards for the capital, labour and enterprise supplied by some or all participants within it, with such reward being capable of variation from period to period without tax discrimination arising and with these rewards being treated as consistently as possible for tax purposes so that there is little or no incentive to misstate the payment made for taxation reasons;
4. The entity should be as straightforward as possible to manage and should have no greater, and preferably less administrative burden than current small limited companies;
5. For the sake of creditors of these entities transparency and accountability should be no less than that required of a small limited company.

### A resolution - the LLP

It so happens that there is already in existence in the UK a legal entity that can provide the framework for solving this problem if appropriate incentives are given. This is the Limited Liability Partnership (LLP) which became available in the UK on 5 April 2001. There were 26,500 such entities in the UK in July 2007 according to Companies House, or 1% of the number of limited companies.

An LLP has the following characteristics:

1. It is legally distinct from its members;
2. It can own property and contract in its own name. This is important; for example the members of an LLP are protected from liability to their employees so long as they have acted in good faith. The self employed are not;
3. The members are only liable for the debts of the partnership if they have been reckless with regard to its management or have been personally responsible for its negligence. In other words, the partners can be protected from each other even when a partner might be exposed to claim from a third party;
4. There is no share capital in an LLP;

5. How profits are divided in an LLP is for the partners to decide so long as taxation law is not offended;
6. An LLP is transparent for taxation purposes i.e. the partners (or members as they are officially called) are charged to income tax on the profits attributed to them by the partnership and those profits are subject to Class 2 and Class 4 National Insurance as if the partners are self employed;
7. An LLP has to prepare accounts in similar form to and with the same requirement that they be placed on public file as is the case for a private limited company;
8. An LLP does, however face substantially fewer administrative burdens than a private limited company does:
  - a. PAYE need not be operated on payments to an owner for employment reward. In an LLP taking cash out of the business is not a taxable event;
  - b. An LLP cannot pay dividends, but nor does it need to do so: the whole administrative process is avoided as a result;
  - c. The members of an LLP cannot suffer 'benefit in kind' charges and as such the whole charging arrangements for these and expense reimbursements which adds considerably to the record keeping burden for the very small limited company is avoided;
  - d. An LLP has to be prepare a tax return but in doing so all the data for the member's own tax returns is prepared meaning that preparation of these tends to be much easier than the return for a director of a small limited company.

It is immediately apparent that:

- The requirement for a separate legal entity is met by an LLP;
- That entity has limited liability protection from the public, and as importantly, from other members;
- The administrative burdens of this structure are easier than for a company;
- The rewards paid by an LLP may be aligned with the underlying way in which the contribution is made by the member without tax

prejudice resulting. As a result some of the taxation inequalities shown to arise in diagrams 1 to 4 noted above can be addressed;

- The status of having a separate trading entity is achieved;
- An accountant still has a significant role to play in the operation of such an entity without burdening a client with unnecessary cost;
- Creditors are protected because accounting information has to be put on public record.

### Problems to be solved

Immediately it can be seen that there are advantages arising from the use of such an entity. However, not all problems are solved:

1. It is not clear that an LLP overcomes the objection of a person engaging a consultant who wishes a legal entity to be placed between the two so that the 'IR35' risk with regard to failure to operate PAYE is transferred to the consultant's company;
2. There is tax risk in transferring a trade owned by a limited company to an LLP: a capital gains charge can arise in the company on the transfer to an LLP taking place even though the ultimate beneficial ownership has not changed. This is a major impediment to people switching from using limited companies to using LLPs;
3. A limited company cannot be re-registered as an LLP, instead the trade has to be transferred and bank accounts, all contracts and employments etc., all have to be transferred from one to the other, with considerable cost arising as a result. This is, again, a major obstacle to re-registration, especially as a stamp duty charge may also arise on the transaction;
4. The tax charge in an LLP can be higher than in an equivalent limited company because the profits of an LLP are subject to national insurance and dividends from a limited company are not when received by an individual. An LLP is, however, likely to have lower administration costs than a limited company and will still have a somewhat lower effective tax rate than would an individual taxed on the same gross sum if paid as a salary, as noted above. This does, however, still provide incentive to incorporate a company;

5. An LLP can be used for ‘income switching’: a partnership share can be attributed to someone with a low tax rate who has not worked for it.

### Solving the issues

Each of these issues can be solved:

1. A statement by HM Revenue & Customs could make it clear that IR35 does apply to Limited Liability Partnerships (as is in fact the case). In that case it could be made clear that so long as the person engaging a consultant was not knowingly party to a tax avoidance arrangement from which they hoped to benefit then they might when making payment to an LLP be entitled to assume that any risk with regard to the operation of PAYE has been shifted to that entity and away from themselves. This would, it must be stressed also suit HM Revenue & Customs: the tax liability in an LLP always involves payment of some national insurance above quite low limits and this need not be the case with limited companies so they win from encouraging the arrangement whatever happens;
2. It should be made possible to re-register a private limited company as an LLP. This would not require a change in the nature of the entity: the old limited company would now assume LLP status. In that case there would, for example, be no need for the closing and re-opening of bank accounts or for the renegotiation of contracts or the assignment of the ownership of property: all would continue with the entity which would instead change its state. Membership of the LLP would have to be offered to all those previously members of the limited company and in the same proportion as before re-registration too place. Reserves would be attributed to members on the same basis with suitable anti-avoidance provisions being included in tax legislation but with intention to be used only when there was no apparent commercial justification for the re-registration. No tax charge should arise on re-registration except that reserves attributed to a member should be considered an income distribution at that time. This will be of only very limited concern to most smaller companies. Where that is not the case an option to spread the liability over a limited period of, say, three years should be made available to ease the burden on transition. The base cost of the shares in the company should be considered the base cost for acquiring the interest in the LLP for capital gains purposes. Any losses

within the company should be attributed to the members in ratio to their ownership to be offset only against future income arising from the LLP.

3. The incentive to register a limited company should be reduced. There are two ways to do this:
  - a. Increase the minimum required share capital. If set at a level of only £20,000 this would discourage the vast majority of small businesses from registering as a limited company and would reserve this form of company for the type of entity which requires to raise capital funding for the activity it undertakes. This makes commercial sense;
  - b. The distribution of dividends by limited companies should be subject to additional taxation in the hands of UK resident persons. For those who income split within limited companies in which there is just one member it is the avoidance of national insurance that provides them with their reward. It is too much to expect that national insurance will be merged into income tax: there are major obstacles to doing so including the resulting unfair tax obligations that will arise on many pensioners and the disadvantage that a high headline tax rate appears to have when managing the shadow economy. It is, however, possible to charge investment income to an additional tax as part of the overall income tax charge. This was done in the UK until 1984. Investment income for these purposes would be:
    - i. All dividends whether from companies or other incorporated saving vehicles and whether the origin is in the UK or not;
    - ii. All distributions from trusts bar those established for charitable purposes or for the disabled;
    - iii. All interest or its equivalent, including rolled up capital distributions;
    - iv. Rents receivable.

Investment income would not include any pension payment from a State or a recognised pension fund.

All persons above pensionable age would be exempt from the charge in its entirety.

To make such a charge both fair (in terms of comparability with national insurance) and to reduce its administrative burden it would be appropriate that an initial amount of investment income be exempted from the charge each year: a sum of £5,000 seems appropriate.

If the rate were set to be equivalent to the employee's national insurance charge then the incentive to incorporate would be dramatically reduced. Since the employer's national insurance charge is not capped nor should liability to this charge be capped either.

It is estimated, based on HMRC data, that this charge might raise a sum in excess of £3.8 billion per annum which is significantly more than the sum lost by income splitting. Allowing for recovery of part of the sum lost by income splitting as well it is likely that this charge might allow the reduction of the base rate of income tax by at least 1%.

4. Finally, the question that started the whole debate has to be answered: how is income splitting to be stopped since even with an LLP this can pay? It would seem that the issue is a tripartite one a three part solution is needed. The following is suggested:
  - a. That a rate of return may be paid on capital employed by the LLP on the partner's combined capital and current account. This should be a risk based return and so should be set at a reasonable interest rate of at least 10%. The balances used should be those at the start of an accounting year or the calculation becomes circular. This payment would count as investment income under the rules suggested here.
  - b. That a part of the income of any small business be attributable to management activity including administration. This might be 10% of turnover up to a turnover limit of £200,000 with a flat £20,000 being allowed for enterprises above that size unless they wish to argue their case for another sum. This sum can be allocated as the reward for enterprise to members as those members see fit so long as all members who participate in the



reward for labour effort expended receive a share of not less than  $1/(1 + n)\%$  thereafter where  $n$  is the number of members. So, for example, where there are two partners only one of whom supplies services to clients and the turnover is £100,000 then £10,000 may be allocated to management activity, the partner supplying client services must receive £3,333 but the balance could be paid to another member without question being asked. That member could also get interest on their capital.

- c. The remaining reward shall be split in the ratio of the effort expended by those supplying services on behalf of the LLP to customers, or who can be shown to have a key role in doing so if not facing the supplier themselves. This is largely a matter of fact. In the Arctic Systems case it was obvious that only the husband had the necessary skills to supply the IT services that the company contracted to deliver. This will be so in the vast majority of such cases. If it is not then the LLP may put forward alternative argument as to why income should be allocated differently if it so wishes, with evidence being required to support the claim. This evidence will form part of the required books and records of the business. Guidance on how the partner delivering services to the client is to be determined would need to be issued. This might be best done by the use of a web site which would allow the input of data that would produce an acceptable profit sharing ratio based for example on:
  - i. Time expended;
  - ii. Evidence of management input e.g. attendance at meetings, client premises, emails sent, etc.;
  - iii. Evidence of key services supplied e.g. technical input, invoicing, project management, product sourcing, etc.

If no evidence can be supplied of a split in these categories (and many companies are very bad at keeping any form of audit trail of what they do) then the default position will be that all labour effort expended will be assumed to be undertaken by the partner most technically skilled to undertake the services the organisation has contracted to supply, so placing the onus of proof on the taxpayer.

It is not suggested that this technique will produce a perfect solution in every case: that is not possible. What it does do is produce a an

acceptable default position for situations where the partners / members are related, turnover is relatively small (it is assumed that this model would not be used if turnover exceeded £200,000), the LLP supplies the services of one or more of its members in the main and at least one partner's role in the business is to supply support services relating primarily to management and administration matters.

By doing so it reduces, as far as is possible the inequalities of the form  $(HC_p + HSp + HE_p) < (HC + HS + HE)$  and  $(WC_p + WSp + WE_p) > (WC + WS + WE)$  (or vice versa) noted earlier in this paper. In other words, the disparity between the economic reward generated by each participant in the company and the reward that they are paid for taxation purposes is realistically aligned and as such tax compliance has been promoted. The result is tax justice.

## Conclusions

This paper shows that there is a problem of 'income shifting' in small limited companies at this time that does result in tax avoidance. The payments made by these companies to those who participate in them might not reflect the economic rewards due to those participants based upon the real value of the inputs they supply to that company and as such the arrangements are not tax compliant, which is the test for acceptability used in this paper and increasingly commonly by HM Revenue & Customs.

The paper then shows that this problem of 'income shifting' within privately owned limited companies is probably insoluble within the existing constraints under which those companies are operated: they were not designed for the purpose for which they are being used and cannot be adapted to fit without compromising their use in those circumstances in which they have a role to play.

In that case it is argued that any solution to this issue requires:

1. A change in company law to allow the re-registration of small limited companies as LLPs;
2. The introduction of new capital requirements for the incorporation of limited companies, and over time forced re-registration of those engaged in commercial activity that do not meet that standard as LLPs;

3. The introduction of a new investment income surcharge that would have the benefit of reducing the incentive to split income, restore the taxation balance between income earned from all sources and allow a reduction in the base rate of income tax without adding substantially to the burden of administration for taxpayers since those liable will, in the vast majority of cases, already be submitting tax returns;
4. Create new, economically justifiable and verifiable standards for splitting income in LLPs so that the risk of legal challenge to such arrangements will be substantially reduced whilst recognising the significant role that the partners of those who supply their services through owner managed corporate entities play in the undertaking of that activity.

If this were done then:

- a. The administrative burdens for many small businesses would be reduced;
- b. The certainty of the arrangements under which they can operate would be increased;
- c. The rewards that they rightly seek to pay to those who contribute to the management of these companies from within domestic relationships will be rewarded, but within appropriate constraints;
- d. The attraction of freelance status in tax terms would be retained;
- e. The current injustice that sees income from labour more heavily taxed in the UK than income from capital would be eliminated in large part without prejudicing the required favoured status of pensioners;
- f. The incentives for tax planning would be reduced, so simplifying tax administration;
- g. The tax yield might either rise, or a reduction in the tax rate might result.

The challenge in creating such a system is significant, but far from insurmountable. It is the challenge of creating an enterprise culture that meets the needs of the UK in the 21<sup>st</sup> century, and that is a challenge that any government needs to rise to.

### About the author

Richard Murphy is a chartered accountant and economist. He trained with KPMG and was senior partner of a firm of accountants primarily serving the SME sector for 15 years. He has been chairman, chief executive or finance director of ten SMEs. He writes and broadcasts regularly, is now director of Tax Research LLP and is an external Research Fellow at the Tax Research Institute, Nottingham University Business School and at the Centre for Global Political Economy at the University of Sussex.

### Comments

Comments and suggestions with regard to this paper would be welcomed. The address to which they should be sent is shown on the first page.