

How to tackle the crisis in small business taxation

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This weeks 'scandal' at the Student Loan Company, where a director who appears to be an employee has been paid through a personal service company has excited lots of attention. I know there will be more similar stories: I have been called about them.

But I'm not interested in the stories of the people involved; I am more interested in the systemic issues. There are two of these. The first is the problem that small business tax is too complicated and fails to reflect the economic reality of the way in which many small businesses work. The second is that the government through H M Revenue & Customs and Companies House is simply failing to collect the tax due from small companies.

I deal with the first here. I wrote the following in 2007 when H M Revenue & Customs had lost its last major anti-avoidance case against the use of a small limited company to both receive the income of what was claimed to be a disguised employment and which then split that benefit between a husband and wife. I wrote then:

The Arctic Systems case has been widely reported, but much of the [comment](#) made upon it has been high on emotion, but low on analytical content.

I wrote on [this case](#), and as a result was [challenged](#) to produce a suitable response. That I have now done. The full paper is available [here](#). The summary says:

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 21st century, and that is a challenge that any government needs to meet.

As I note at the end of the paper, suggestions and comments are welcome. But please do read the paper first and not just the summary.

That invitation still stands: the problem remains. I remain sure I have offered a viable alternative. I know it was well read and discussed in the Treasury at the time. Is this the time for change?