

Tackling smaller business tax abuse by fundamental refo...

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Right wing 'usual suspect' trolls have been out in force on the comments section of the blog in the last day or two saying I have no answer to the problem of income shifting in small business or dividend abuse and so should not have included tax abuse by dividend payment in UK small companies [in my estimate of the UK tax gap](#) - as if doing so proves that the remaining £118 billion or so is a matter of no consequence. I have deleted all those who are tedious, repetitive, and frequently behind the scenes abusive commentators, precisely because they do not add to debate and also because I have made responses on these issues (I always seek to identify solutions to problems). I [wrote the following blog in August 2007](#) following the conclusion of the so-called Arctic Systems tax case and whilst the numbers have, of course, changed by now the principles of what I wrote have not as no action has been taken by HMRC since then, as they abandoned action on this issue when the recession swept the country. I think it's time to return to this issue:

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 reflect 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.

And please note: I would add that I believe that basic rate tax should be paid on the adjusted taxable profits of all LLPs to HMRC as a payment on account of income tax liabilities, and that this should not be refundable in the case of non-resident persons or corporate members (and yes, I do mean that last point).