Funding the Future

Does the tax profession equate? A little theory suggest...

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This blog was posted on Jolyon Maugham's site a couple of days ago and is now reproduced here, with his permission. I should add that I have already made further comment on it here but post it in full here in case that gives it a wider audience:

When Jolyon asked me to contribute to a discussion in tax and self-employment I reflected on two things. The first is my own experience as a self-employed person, which given my own temperament was probably the only real option ever available to me. The second was the advice I have given to many hundreds (if not more) clients over many years on these two related issues. The result was that I realised, first, that the decision to be self employed has, in many cases, no relationship to tax at all. And, second, that because of the real number of variables involved in the tax decision making process when it comes to self-employment questions anyone who suggests that rational, tax based, decisions are taken is, at best deluding themselves either before the event (if they're a professional adviser with a more expensive product to sell) or after the event if, by chance, savings worked out as hoped.

What the aim of this blog is, then, is to show just how many variables there really are in this decision process and to show how irrational it is to focus upon any of them for the vast majority of people (98% +) who earn less than £100,000 or so of taxable income each year (i.e. those for whom a focus on increasing net income might be of significantly greater use). In the process I also show that almost no Laffer effect could be reliably predicted for those with the option of self employment earning below £150,000 whilst those earning above that sum in reality face a choice of varying flat rates of tax, making Laffer implications impossible to measure independently of any choice on rate substitution, which is likely to have much bigger impact.

If it gets a bit technical on the way I don't apologise. What I do instead suggest is that it really is time that we had professional advisers in this country who helped businesses make more and create more wealth instead of concentrating on a spurious goal of tax minimisation (which is, as I show, itself meaningless because what it means varies at different income levels, some of which will only be known well after the time when decisions need to be made). In other words, a debate about self employment and tax makes sense, but only in the context of considering all the variables that might be relevant in the equation that relates the issues. And by equation, I mean equation.

There are, of course, issues relating to the tax differentials between the two bases for taxing the income of people in the UK that might have impact on an individual's tax decision making and on national tax yield but this is not, I suggest, a binary choice of either / or employed versus self employed status.

Firstly because this is not the only choice available: there is also the option of incorporating as an alternative mechanism for running a business which in turn gives rise to at least three alternative tax rates, being those on corporate retained income, corporate distributed income via dividends and corporate distributed income via salary, and these three options are all stated before the potential to divert income to others (not considered further here, but a very real factor in much tax planning at the point where it very definitely interfaces with tax avoidance) comes into play.

Secondly, tax payments and so yields are not just impacted by tax rates. The interaction between income and state social security payments, both taxed and untaxed, also has an impact on effective tax rates, whilst the capacity of the taxpayer to save in tax enhanced ways (ISAs, pensions, VCTs, etc) has to be taken into account, as too does the capacity of the chosen mechanism for declaring income to facilitate tax evasion, the offset of expenses incurred in relation to work related activity and even the opportunity for recategorising income as gains need to be taken into account.

Do all this and something like the following, simplified, equations, come into operation when considering effective tax rates, assuming that:

B = Tax base
P = Non-discretionary allowances
U = Untaxed social security payments
W = Taxed social security benefits in period
A = Discretionary allowances
V = Evaded
X = Expenses
S = Tax relieved savings in period
G = Capital gains
R1 = Employed tax rate
R2 = Self employed tax rate
R3 = Corporate savings rate
R4 = Distributed corporate tax rate
R5 = IR35 tax rate
Z = Capital gains tax rate
T = Tax paid
E = Effective tax rate
Y = Gross pre tax income
E = Effective tax rate
N = Net income

After which it follows that

T = (B-A-V-X-G)Rn + GZ

Where n = 1 to 5

And B = Y — P — U

And A = S — W

And F = T / Y

And N = Y — T

The question that then needs to be asked is what a person's objectives might be in the above equations, and whether or not that objective remains consistent at all points in the income cycle or for all people at any point in that cycle.

It is also important to note that given the extensive range of variables and rates noted (even assuming national insurance and income tax rates are merged) and that the tax rate R is in in many (but not all) cases not an independent variable in this equation as it varies with the outcome of the expression (B-A-V-X-G), then the variables prioritised for ex ante decision making will almost certainly represent estimated data at the time a decision is taken since in practice in a real world situation the value of many (but not all) variables will only be known after decisions on tax status (even assuming that is unchallenged) have been made. It has to be stressed therefore that real world optimisation of any chosen outcome in this equation is nigh on impossible. Wise people should, and would, recognise this fact.

Despite this a rational economist (a term not necessarily synonymous with a wise person) would say that the decision a person should make is to maximise N, which is net income. But economists do not understand human beings, and many real people will for wholly rational reasons not do this, because they have other intellectual and emotional objectives (see *The Courageous State*) *or simply do not prioritise income as the most important thing in life, and so income maximisation is not just a constrained opportunity for some (which it can be for others), it can also not be a choice in the sense that a person simply satisfices in this area.*

In that case can it be assumed that another objective (either tax minimisation, or tax rate minimisation or marginal tax rate minimisation, and all could be set as goals) make sense? Maybe, but probably only if you are an accountant, lawyer or large corporation so remote from normal human objectives and conflicting interests that such a proxy for rational behaviour is even considered a priority. That said, precisely because so few accountants and lawyers do have much idea how to maximise income, even if that was a client's actual objective (and I never in my practising career heard a client say it was) I am quite sure those professional people do adopt one of these tax related proxies for rationality instead, in the process hoping to hide their inability to offer business advice or even listen to their client's stated preferences.

However, this may be quite irrational behaviour on these professional people's part. The evidence for the importance of any of these tax related goals is limited. Well over 80% of all people working in the UK choose to be employed even though this is likely to increase their tax rates (R1 is greater than R2 which is greater than R4, for example, almost invariably and across most income ranges) and reduce opportunities for evasion, expense deduction and conversion of income into lower taxed gains. Either all *of these people are economically crazy or there is something else at play here.*

Even when self-employment is chosen as an option the likelihood that a person will risk tax minimisation (legally or illegally) is low. HMRC think that more than 40% of all self employed people under declare income on their tax returns. I believe, in addition, that the number making returns compared to those who should do so is significantly understated. But there still remain a substantial number who, nonetheless, do declare their income reasonably accurately whilst every year financial advisers suggest billions in available tax reliefs are not used by those who had opportunity to claim them. So even though tax advisers may think tax minimisation is a priority the reality is that the evidence does not support that fact.

This is not to say that tax does not impact on behaviour; it very clearly does. But, first of all, this evidence suggests that it may have relatively little impact on the decision to be self employed or not. In addition, the impact it may have might vary considerably depending on the values and priorities given to different variables in the equations noted at varying points in the income profile. So, for example, at some points the impact of the marginal tax rate (I could start expressing these variables mathematically but will resist the temptation to do so for risk of alienating most readers) will be very high. This might be especially true when there is a significant withdrawal of social security benefits (W). At other points this may arise because of the withdrawal of non-discretionary allowances (P). At other points the impact of rate substitution (R4 for R2, for example) might justify a reduction in net allowances (actually, in this case an increase in real costs with advisers, who do, I suggest, motivate much of this decision for that reason, by the way). And so on.

But with all these options, is the tax profession really able to advise rationally without either broadening its skill base or the adoption of bogus proxies for rationality (already noted). That is the first question?

The second question is whether we are in fact asking the right questions of tax design and our reaction to it when faced with all these options. That would have to be the subject of another blog. I suspect the answer is that at present we are simply failing to understand the real reasons for tax design when thinking on this issue. We are being blinkered in our focus on tax paid to the social dimensions of tax design.

And third, let me raise the question Jolyon Maugham has asked me to consider when writing this blog, which is where is Laffer in all this and, indeed, the issue of progressive taxation in all this? The only sensible answer I can give is, that to a very large degree, neither is anywhere to be seen at all. Firstly that is because much of the decision making that impacts the decisions noted has to be taken before facts, including income, are known. Therefore the impact of rates is assumed, and not known. Second it is because some residual factors, e.g. use of tax deductions for pensions can be used ex post to vary outcomes, and third, and most important, tax is just not that important to the vast majority of people, self employed or otherwise to go through all the necessary *decision making processes (which might explain the appeal of evasion to some).*

But perhaps, fourthly, and most importantly, over the income ranges where tax rates on earned income, however derived or recorded, vary significantly (i.e. at levels broadly speaking below £100,000 and definitely below £150,000) tax is not by a long way the most important factor in determining choice on employment versus self employment and so net income outcome. Work availability, career choice, social priorities, personal risk preference and a host of other factors will impact the decision much more significantly over this income range, not least because many within the income bracket of £150,000 or less will think they need most of their income to live on or to compulsorily save for a pension. Serious tax planning only happens at higher income brackets where more significant discretionary funds are available and in that case Laffer plays no effective part at all in the UK as rates are then flat, if albeit, substitutable (which is where planning comes into play, with most impact being the fact that R1 > R2 > R3, and this creates a regressive tax regime for many).

So what conclusion do I reach? There are several.

The first is that tax professionals over-emphasis the importance of tax to others.

The second is that tax optimisation, taking into consideration the variables I note (and there may well be others, but they only complicate matters further) requires, firstly, perfect knowledge of the future that none of us possess and secondly analytic ability to consider a a range of variables so complex most would not try to resolve the issue in any rational way.

Thirdly, in the face of these first two factors tax professionals try to sell pre-packaged solutions (e.g. incorporation as a route to national insurance minimisation) without ever being fully aware of its potential implications for the client whose interests they may not have properly noted. The chance that this is because such pre-packaged solutions enhance adviser income cannot be overlooked.

Fourth, if there is one variable designed, above all others to impact in N (net income) in the equations noted above it is Y (gross, pre taxed income) and it is time that the accountancy profession, in particular, reframed its thinking about how to help clients maximise this rather than minimise tax.

Fifth, if Laffer effects are so unlikely to be measurable in any scenario likely to be considered, why do we worry about them?

Sixth, given the substitutability of tax rates right across the income spectrum considered here (effectively from almost zero to infinity, if you wish) the chance that the Laffer effect will ever have impact at the rates available (bar short term shifting as seen with the 50p tax rate) is very low indeed, and to extrapolate from short term income shifting to long term behavioural impacts of tax is a step that no one should *take.*

Seventh, the impact of the integration of tax rates with tax spending (i.e. how rates are impacted by benefits and allowances and reliefs as well as indirect tax benefits of government spending) is always understated in a discussion of the sort I have attempted here. In reality tax and spend are part of an integrated whole process and not to be seen in isolation of each other.

Last, given all those factors, shouldn't we realise that tax is not designed solely for revenue raising purposes but for any other social and economic reasons as well and that all we are looking at is the reaction to those various deliberate and often intended consequences of that design process with too limited a lens when we consider tax rates in isolation? Many people, from my experience, choose not to do so, thinking that tax is, as I said at the outset, of overstated importance in their decision making processes and that they really would prefer that their advisers take more nuanced approaches.