Andrew Hubbard outlines the changes ahead for the taxation of small business.

Produced by Taxation Magazine

Key Points

- The changes to dividend tax are the start of a process to reduce the tax advantages of incorporation
- For existing companies dividends are still generally more tax efficient that salary, though the advantage are reducing
- IR 35 and personal service companies are back on the government's agenda
- The OTS has been asked to look again at the alignment of tax and NIC and at small company taxation generally
- There will be much to talk about with clients -- many of them could face significantly higher tax bills next year.

I wondered what on earth the chancellor meant when he extended yet again his litany of objectionable tax practices during the budget speech. Evasion, avoidance and aggressive tax planning, we understand -- but imbalances? What are they? It is now clear that one of those imbalances that he seeks to address is the taxation of small companies. We are in for considerable changes over the next few years.

We have been here before -- indeed I seem to have spent considerable parts of my career grappling with these imbalances. There are, in essence, three separate tensions within the system which make rational policy making so difficult.

- Employed versus self-employed
- Incorporated versus unincorporated
- Dividend versus salary

Any change in part of this triangle has knock-on effects elsewhere -- does anybody remember the ill-fated non-corporate distribution rate? The result is that the taxation of small business in this county is far too complex and creates distortions and sometimes produces arbitrary results. Let's be honest, some of those results are in our client's favour and so removing distortions will create losers and well as winners. But I've yet to meet anyone who really believes that what we have at the moment is a sensible and coherent system: change is necessary.
Seeing the bigger picture

So what is happening? After a couple of days reflecting on the budget announcements I am starting to see what I think are the overall themes, although many of the details need to be firmed up. I’m writing this in advance of the publication of the Finance Bill so what follows will need to be reviewed against the small print.

The most obvious change is in the taxation of dividends. From next year dividends will have no tax credit attached (thus removing the often confusing distinction between "gross" dividends and "net" dividends) and the amount received will be all that matters. Dividends will be taxable at 7.5%, 32.5% and 38.1% respectively, depending on the marginal rate. As we will no longer have to take into account the grossed-up amount of the dividend in determining which rate band somebody falls into there are likely to be some odd results close to the rate band changes.

Those rates represent real increases in tax. The blow is, however, softened by the introduction of a £5,000 dividend allowance for all taxpayers. The assumption is that this will mean that an individual who receives total dividends in a year of £6,000 will be taxable on £1,000. I did see some commentators suggest that it meant something different: that if the dividends were less than £5,000 no tax was paid, but once they got to £5,001 tax was paid on the whole amount. I don’t think that that can be right but, until we see the legislation, we can’t be certain. I will assume in the rest of this article that the former reading is the right one.

What’s the objective?

Why has he done things this way? First, I believe that the £5,000 limit is all linked with digital tax accounts. Just as we saw earlier in the year with savings income, taking out small amounts from tax should reduce the compliance burden considerably. A typical self-assessment taxpayer whose dividend and interest income are small should have little to enter onto his digital account (I say should because we don’t yet know the mechanics of all this). Second, the changes will raise more tax from those few extremely wealthy people with massive dividend portfolios. But third, and this is the key change, it will directly affect small businesses.

Salary v Dividend

<table>
<thead>
<tr>
<th></th>
<th>Salary 2015/6 and 2016/17</th>
<th>Dividend 2015/6</th>
<th>Dividend 2016/17</th>
</tr>
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<tbody>
<tr>
<td>Amount to be extracted</td>
<td>£10,000</td>
<td>£10,000</td>
<td>£10,000</td>
</tr>
<tr>
<td>Net drawn for employer’s NIC (13.8%)</td>
<td>£8,787.35</td>
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<td>Income tax on earnings</td>
<td>£1,757.47</td>
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<tr>
<td>NIC 12% on earnings</td>
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</tr>
<tr>
<td>Dividend tax allowance</td>
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<td>n/a</td>
<td>(£5,000)</td>
</tr>
<tr>
<td>Taxable dividend</td>
<td>£0</td>
<td>£10,000</td>
<td>£5,000</td>
</tr>
<tr>
<td>Net tax on dividend (0%/7.5%)</td>
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<td>£0</td>
<td>(£375)</td>
</tr>
<tr>
<td>Additional corporation tax</td>
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<td>(£2,000)</td>
<td>(£2,000)</td>
</tr>
<tr>
<td>Net cash in hand</td>
<td>£5,975</td>
<td>£8,000</td>
<td>£7,625</td>
</tr>
</tbody>
</table>
The budget Red Book is clear on this. It says at 1.189:

"These changes will also start to reduce the incentive to incorporate and remunerate through dividends rather than through wages to reduce tax liabilities. This will reduce the cost to the Exchequer of future tax motivated incorporation (TMI) by £500 million a year from 2019-20. The tax system will continue to encourage entrepreneurship and investment, including through lower rates of corporation tax."

There are two limbs to this: incorporation and dividend versus salary. Let’s take them in reverse order. A low-salary, high-dividend route still looks to be more tax-efficient even after these changes. Everybody has a different way of doing the comparison. I like to keep it simple and look at a basic rate taxpayer who has used up his personal allowance against salary and is looking to take another £10,000 out of his company, as shown in Salary v Dividend.

This confirms that the dividend route is still more efficient. This is consistent with what is said in the Red Book with its reference to "start to reduce the incentive". I can only read that as a very strong hint that dividend tax rates will eventually be ratcheted up to align salary and dividends. The chancellor hasn't done it by putting National Insurance on dividends -- with all of the problems that would have caused elsewhere in the tax system -- but the new dividend tax is in some ways a back door way of doing the same thing. So the message to clients is: expect to pay more tax next year. If, as a result, they question the chancellor’s triple-lock announcement about no increases in tax rates, this query might be passed to 11 Downing Street.

Tax motivated incorporation

What about the other element -- the tax-motivated incorporation? Many people incorporated their businesses at the time of the 0% corporation tax band and, to an extent, all actions taken since have been trying to close the stable door after the horse has bolted. But these new changes are intended to discourage individuals from incorporating purely to obtain a tax advantage. The computations here are trickier because we do not yet know the National Insurance bands for next year and therefore complete precision is not yet possible. But the tipping point at which incorporation starts to deliver significant tax systems has clearly gone up. It looks as if incorporation at earnings even as high as £30,000 will now deliver a very marginal benefit.

I think of it this in the following broad terms. The advantage of incorporation has been that much of the income could be received as a tax-free dividend. Of that £30,000, something like £20,000 could be taken as dividend (using the personal allowance to cover salary). Next year that £20,000 will create additional tax of £1,125 (£15,000 x 7.5%). That is a significant increase whereas, broadly speaking, the self-employed will see little change. Additional tax at that level would make incorporation much less attractive.

In our heart of hearts we all know some taxpayers who could not cope with operating through a company. The additional hassle of dealing with benefits in kind, loans to participators and company returns is often a nightmare for them, and hence for advisers. With the tax benefits of incorporating being reduced (and I expect them to be further reduced in the coming years) there is a lot to be said for them to remain as self-employed.

For those who are already incorporated, there will be different considerations. Some will be happy to operate in corporate form -- indeed their particular industry may not allow them any
other option -- but others may start to wonder whether it is time to disincorporate. We do now have a disincorporation relief. I think it has been little used to date, but presumably we will have to dust off the legislation to see whether it will work in our clients' circumstances. There will be plenty to talk about at client meetings.

Other changes

The dividend tax was not the only small business measure. Personal service companies are back on the agenda. There is not only the decision to withdraw the employment allowance for one-person companies, but yet another review of the IR35 provisions to "find a solution which protects the Exchequer and improves fairness in the system".

So where does this leave us? As I have said many times over the years the system for taxing small businesses lacks any coherence. What we have is the result of various strands of the tax system designed for different purposes all crashing together on the small businesses that are the lifeblood of the economy. This creates complexity and administrative burdens. We need a system designed specifically for small businesses and which addresses the triangle of tensions outlined above.

Themes of the moment

This is where two of my recurrent themes in recent weeks come together: the Office of Tax Simplification (OTS) and the digital strategy. The OTS is to be established on a permanent basis with enhanced resources and a wider remit. It has been given two immediate tasks by the chancellor: to review the taxation of small business and the potential for closer alignment of income tax and National Insurance.

There may be a sense of deja vu here given that those were some of the first topics addressed by the OTS when it was set up. Some good work was done by the OTS in those projects (I declare an interest as a member of one of the consultative committees) but there was a general feeling of disappointment that the government didn't want to follow up on the recommendations for structural reform that were made. By asking the OTS to look again at these issues, I really hope that this time we can get to a position where there is serious debate about sort of tax system we need for small businesses rather than minor tinkering around the edges.

The other issue is the digital agenda. I make no apologies for coming back to this -- I can't stress enough how much it now underpins the whole of HMRC's thinking. I've already commented that the £5,000 dividend exemption is a way of taking admin out of the system.

But there is more to it than this. If I operate through "Andrew Hubbard Ltd" I must have several digital interactions with HMRC -- as an employer, a corporate tax payer and as an individual. But if I operate purely as "Andrew Hubbard" there is only one interaction.

It seems to me that HMRC would love to get into a position where there was only one digital interaction with each citizen. Partly this could achieved by persuading people to disincorporate, but it would be greatly facilitated in a system whereby there was tax transparency. In that case, even if I still operate through a company (which, for the avoidance of doubt in case the office dealing with my tax is reading this, I don't), there would just be a single level of tax for everything that I do, whether personally or corporately.

Bringing together the OTS and digital strategy is vital. It is possible -- a long shot I know, but I am an optimist -- that coming out of this could finally be a tax system for small businesses that is fit for purposes. I do know that, if there is not very close working, any attempt at reform will be doomed before it starts.
The message to clients

So what do we say to clients about these changes and the further ones that are almost certain to come?

The first thing is to remind them that the dividend tax does not come into effect until next year, so there is nothing to do immediately. For clients who are considering incorporation, it might be best to put any plans on hold until the position is clearer. This is certainly the case if the benefits are only marginal or if there are concerns about the additional complexity. Clients need to be forewarned that next year’s tax is likely to be higher than this year’s, despite all the talk of tax cuts in the budget.

For those with significant income, where the dividend tax will make a big difference, start thinking about timing of dividend payments next spring. Pre-6 April dividends will be significantly more tax-efficient.

HMRC can be expected to look closely at the timing of dividends paid in March and April next year, so getting the paperwork right will be essential. We will be covering the rules on the timing of dividends in an article nearer that time and we will be monitoring what the OTS comes up with in its latest review.