REGULATORY IMPACT ASSESSMENT (RIA)

Corporation Tax: The Non-Corporate Distribution Rate

Purpose and intended effect of the measure

The policy objectives

1. To focus tax incentives for business where they are most effective to support enterprise and growth.

2. To discourage businesses from incorporating solely or mainly for the tax and NIC advantages without changing their economic activity.

3. To ensure companies and their owners pay an appropriate amount of tax on profits and remuneration.

Background and introduction

4. The Government has introduced a range of tax measures to support small businesses, including reductions in both income tax and corporation tax, payable tax credits for research and development, and cuts in capital gains tax which mean the UK now has the most favourable regime for business capital gains amongst all major developed economies.

5. Chapter 3 of the Budget Report[1] sets out further measures to support small firms, and to encourage them to innovate, invest and grow. This includes, in response to requests from a number of industry representative bodies, an extension of first year capital allowances for small firms investing in plant and machinery to 50 per cent from 1 April 2004 for one year, after which the measure will be reviewed.

6. As part of this strategy, the Government believes that transition to the corporate legal form can be an important step in the development of a business, and can assist small businesses in realising their growth potential by providing flexibility in access to external finance, improving governance and managing risk.

7. The Government is committed to ensuring that the UK remains one of the easiest places to start and grow a business. As set out in the 2003 Pre-Budget Report, the Government is determined to ensure that the measures it has introduced provide support for firms taking on the opportunities and responsibilities involved in that transition, by encouraging them to reinvest their profits and grow their business.

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[1] Full report on available at www.hm-treasury.gov.uk/budget/budget_04/bud_bud04_index.cfm.

The risk(s) being addressed

8. The Government is therefore concerned about the increasing numbers of self-employed individuals adopting the corporate legal form where the change is made for tax reasons rather than as a step to growth, often as a result of marketed tax-avoidance schemes. Following the announcement in the 2003 Pre-Budget Report, the Government has reviewed options for more closely aligning the tax paid by these individuals with their economic characteristics.

9. Having considered a range of options, the Government is determined to proceed in a way that protects the benefits of low tax rates for those investing in their businesses. With effect from 1 April 2004, the Government will therefore introduce a 19 per cent minimum rate of corporation tax on distributed profits. This measure will ensure that corporate tax rates lower than 19 per cent, including the zero rate of corporation tax introduced in April 2002, remain available to small companies as they re-invest in their business. Businesses re-investing their profits, or companies with taxable profits above £50,000, will be unaffected by this measure.

Options

Do nothing

10. If no action were taken then the rate of tax-motivated incorporations would continue unchecked with a significant increase in the deadweight costs of the Government's growth and enterprise policies. There would be increased unfairness in the treatment and taxation of profits extracted by company directors compared with the treatment and taxation of the profits of unincorporated business.

Increase or abolish the starting rate of corporation tax

11. In terms of ease and speed of implementation, this would be the most straightforward option. However, it would run counter to the Government's aim of maintaining low rates of corporation tax to encourage growth and enterprise. And it would penalise those companies that did retain profits to fund future growth and enterprise. And raising the starting rate back to 10% would only partially address the issues because the tax benefits of incorporating would continue to outweigh any disadvantages.

Raise tax on dividends received by directors of close companies and their associates

12. This option would retain the current tax incentives for companies and would address the unfairness inherent in directors being able to take their remuneration out of the company in a no or low tax form. However,

there are significant difficulties in identifying what amounts received by directors in the form of dividends were, in reality, remuneration and what an amount representing a return on capital. Attempting to do this would involve the application of difficult and subjective judgements on a case by case basis with very high compliance costs – both for taxpayers and the Inland Revenue. Significantly, it would do little to address the issues at the corporate level – particularly the continued distortion in decision making as to the most appropriate legal form for the business.

Minimum rate of corporation tax on distributed profits

13. This option would encourage the retention of profits (in order to fund future growth and enterprise) by retaining the current starting rate of corporation tax for profits as long as those profits were retained within the company. But if the profits were distributed (usually by way of dividends) then a relevant amount of company profits would be charged at a minimum rate of corporation tax. The system would be mechanical, involving no subjective judgements, and in theory apply to all companies. This option does result in some additional compliance costs for companies, both in identifying distributions made to persons other than companies and in the calculation of the overall corporation tax charge. But overall these are considered to be modest and far less difficult and onerous than the preceding option of raising taxes on dividends.

How the options were considered

14. The pro and cons of all the options were considered under the following headings:

- the Government's growth and enterprise objectives;
- types and size of company likely to be affected;
- objective versus subjective application;
- impact of and on the extraction of profits in a variety of forms;
- European Law;
- Inland Revenue operational implications;
- Human Rights issues;
- wider policy objectives;
- ease of understanding and application by business; and
- business compliance costs.

15. The recommended option is that of charging a minimum rate of corporation tax of 19% on distributed profits, to be known as the "Non-corporate distribution rate" (NCDR). It is proposed that this option should apply in respect of profits distributed on or after 1 April 2004. This preserves the low rates of corporation tax for those companies that re-invest in their business. The new measure will only apply where profits are distributed to persons other than companies and where the company's profits are chargeable at less than the small companies' rate of corporation tax (currently 19%).

Example

A company has basic profits for an accounting period of £40,000. The distributions made in the accounting period totalled £35,000 of which £5,000 were made to a company and £30,000 to shareholders who are not companies. The tax computation would be:

Basic Profits	*£40,000*	*@ 19%*	*= £7,600.00*
Less : Marginal Rate Relief	*(£50,000 – 40,000 x 19/400)*		*= £ 475.00*
Corporation Tax due on basic profits			*= £7,125.00*
the underlying rate is	*(7125.00/40000 x 100)*		*17.8125%*
Total CT due:	*£10,000 @*	*17.8125%*	*= £1,781.25*
	£30,000 @	*19% (NCDR)*	*= £5,700.00*
			£7,481.25

Business sectors affected

16. The new rules will apply to all companies – therefore they will apply to all business sectors without discrimination.

Issues of equity and fairness

17. Business is carried out in fundamentally different legal forms and so it is neither possible nor desirable to tax unincorporated businesses and companies in precisely in the same way. Nonetheless, the proposal will ensure company profits are taxed more fairly by reducing the differential in tax compared to unincorporated business.

Benefits

18. The chosen option preserves the benefits of low corporation tax rates for those companies that retain profits to fund future growth and enterprise. It provides a better focus for Government policy and significantly reduces Exchequer deadweight. In addition, by reducing the incentives to incorporate solely or mainly for the tax advantages, business will be able to make decisions about the most appropriate legal form by reference to all relevant commercial criteria.

Costs

Policy costs

19. Not relevant – as there are no direct costs that the policy requires companies to incur, only the indirect costs of complying with new tax rules.

Implementation (compliance) costs

20. There may be some modest increase in companies' administration costs or accountants' fees in determining if the rate of corporation tax to be charged on profits is to be computed by reference to distributions made to persons other than companies in the relevant accounting period. This will not require companies to maintain any additional records over and above those already required by company law.

21. However, from the Inland Revenues' analysis of the corporate business population we believe that most companies who are liable to pay corporation tax at less than the small companies' rate are unlikely to have corporate shareholders. As a result the additional compliance costs should be very modest.

22. There will we some initial familiarisation and conversion costs for accountants, business and providers of tax software – but these will also be very modest because of the relatively simple design of the chosen option. Furthermore, the Inland Revenue will support business and their advisers with guidance and explanatory material. For example, a Hotline was set up to take queries on the distributions rate of tax from Budget day and question & answer material was made available on the Inland Revenue website shortly after the Budget.

Exchequer effect/ distributional impacts

23. The measure is expected to yield £10 million in 2004/5, rising to £340 million in 2005/6 and £490 million in 2006/7. But it should be noted that, alongside the revenue raised by this measure, tax revenue has been reduced through self-employed individuals incorporating in order to save tax.

24. The measure will affect only companies generating less than £50,000 profits per year. It will help to ensure that the tax paid by those companies is more closely aligned with that paid by self-employed people on the same incomes, thereby improving the fairness of the tax system.

Small Business impacts

25. Of the 3.7 million small businesses[2] in the UK, around 2.9 million are unincorporated and 830,000 are companies[3]. Unincorporated businesses would be unaffected by changes to corporation tax unless and until they incorporate. For those within the corporate sector it would only affect profitable companies whose profits are less than £50,000,

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- [2] Small businesses are defined here as businesses with less than 50 employees.
- [3] Source: Small Business Service SME statistics, 2001

and which chose to distribute their profits to non-corporates (eg individuals).

26. The number of companies affected by the measure will depend on the impact of the higher tax rate on non-corporate distributions, or alternatively the extent to which they choose to retain and reinvest their profits instead. Estimates based on Inland Revenue and Companies House data suggest that under 40% of small companies might be affected by the measure in any one year.

27. Because of Budget confidentiality, it was not possible to formally discuss the options with business or their advisers. However, following the announcement in the PBR in December 2003 and as part of the normal Budget representations process – the Inland Revenue team attended a number of meetings and seminars organised by business and their representatives such as the Small Business Service to listen to their concerns. The Inland Revenue team also closely monitored comments in the professional press, on Internet sites set up after the PBR announcement and in correspondence, to identify issues that concerned business.

Other costs and benefits (public & private sector)

28. There will be extra training costs to allow Inland Revenue operational staff to deal with queries from businesses and their advisors. There will be additional costs to amend the corporation tax return and the Return processing systems. The costs will be fairly modest, in the region of £300,000.

Unintended consequences

29. None anticipated.

Other impacts

30. Human Rights - both Inland Revenue Solicitor and Counsel have confirmed that the recommended option will have no adverse implications.

31. Devolution - Corporation Tax is a national tax and so there are no issues.

32. Environment - none

33. Rural communities - none

34. E-business – no adverse impact anticipated.

Competition assessment

35. The measure is unlikely to have a direct impact on the intensity of competition since any increase in compliance costs would not significantly affect the fixed costs of doing business for affected companies. However, it should help to level the playing field between unincorporated and incorporated businesses that are competing in the same market. As a result, market shares should better reflect underlying differences in product quality and firm efficiency, rather than differences in effective tax rates, leading to improved resource allocation and therefore higher productivity.

Securing compliance

36. Companies liable to pay tax at the NCDR will be required to make a self assessment in the same way as any other company. Compliance will therefore be secured, where necessary, in the vast majority of cases, through the usual Corporation Tax Self Assessment enquiry procedures, which have built-in safeguards and appeal mechanisms.

Monitoring & Review

37. The Inland Revenue will continue to monitor the effects of the introduction of the new measure, including on the following:

- the numbers of new incorporations and company dissolutions, compared with both pre and post April 2002 trends;
- the number of companies affected by the measure;
- the effect on business, including any behavioural changes, for example, any increase in the proportion of profits retained and reinvested for growth;
- the effect on corporation tax receipts;
- the effect on ways in which owner-directors take their remuneration from the company;
- the impact of the changes to the Corporation Tax Self Assessment Return and the effectiveness of the guidance produced to aid completion of the new boxes on the return.

Early information gathered from the monitoring and review of the new measure will be used to feed into the discussion paper (to be issued at the time of the 2004 Pre Budget Report) on the issues raised by the interaction within the tax system. This will include definitions of income of self-employment and the remuneration paid to owner managers.

Consultation

38. Because of Budget confidentiality, there was no formal discussion or consultation with business or their advisers. However, the Inland Revenue did attend a number of Budget representation meetings & seminars organised by business and accountants to listen to their concerns in the light of the announcement at Chapter 5.91 of the PBR 2003. In particular, in determining the most appropriate option, considerable weight was given to concerns expressed about:

    - the speed of introduction of at that time an unknown measure;
    - the potential cash-flow effects of any changes – particularly on small businesses;
    - the desirability of avoiding complex measure possibly involving subjective judgements; and
    - the need to minimise the operational and compliance costs for business and their advisers.

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Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo

Paymaster General

Date 6 April 2004