

REGULATORY IMPACT ASSESSMENT FOR CHANGES TO THE CORPORATION TAX STRUCTURE

Introduction

1.1 The Government will replace the non-corporate distribution rate and the starting rate of corporation tax with a single small companies' rate.

1.2 This Full RIA updates the Partial version published alongside the December 2005 Pre-Budget Report.

Purpose and Intended Effects of the Measure

The Policy Objectives

1.3 The Government's objectives for the business tax system are that it should promote productivity and growth by supporting business competitiveness, while ensuring business contributes its fair share to the funding of public services. This measure aims to promote growth of small businesses through better targeting of tax incentives and by simplifying the corporation tax structure to minimise compliance costs and allow firms to focus on growing their businesses.

1.4 Existing incentives for growth have had some success in encouraging small companies to reinvest their profits. However, the benefits of existing incentives are being eroded by increasing numbers of new incorporations, who do not have growth ambitions, but are still able to take advantage of these incentives. The Government's objective is to refocus growth incentives so that the support for and benefits of reinvestment go to businesses with growth ambitions and it is concerned that any incentives should be perceived as fair. Use of the incentives by people being encouraged to incorporate and reduce their tax and national insurance contributions (NICs) liability erodes that fairness

Background

1.5 A range of measures has been introduced by the Government to support small businesses, including reductions in both income tax and corporation tax, and payable tax credits for research and development.

1.6 The starting rate of corporation tax was introduced in 2000 and reduced from 10 per cent to zero per cent in 2002. It applied to companies with profits up to £10,000 per year. Marginal relief was also introduced for companies with profits between £10,000 and £50,000 per year. Above this level, profits were taxed at the small companies' rate of 19 per cent (up to a threshold of £300,000).

1.7 After the reduction of the starting rate to zero per cent, concerns were raised that the benefits of the rate were being used by incorporations not intending to grow. Therefore, at Budget 2004 the 'non-corporate distribution rate' (NCDR) was introduced to ensure the incentive was focused on profits retained by small companies. The NCDR charged 19 per cent on any profits distributed as dividend payments to individuals, rather than retained in the company to fund investment.

1.8 Alongside the 2004 Pre-Budget Report (PBR), the Government published a discussion paper, *Small companies, the self-employed and the tax system* to stimulate debate on how the taxation structure for small businesses could be further improved. A

majority of responses (both directly to the discussion paper and in meetings) requested simplification of the corporation tax structure for small companies. There was also agreement that the zero per cent starting rate of corporation tax, while providing an opportunity for small companies to retain their profits, had led to unfair tax outcomes in comparison with sole traders/partnerships.

Rationale for Government Intervention

1.9 Simplification of the corporation tax structure for small companies allows them to focus on growing their businesses and increasing their profits by reducing their administrative burden. The Government believes that the growth of small businesses is essential for providing flexibility and dynamism in the UK economy. As well as providing innovations and efficiency gains of their own, new businesses with growth potential present a strong competitive challenge to incumbent firms, who are in turn prompted to improve productivity.

1.10 Although the starting rate offers tax advantages for firms that retain their profits rather than distributing them, it also offers tax savings to companies with no intention of growing. Another rationale for change is therefore to better target this support to firms that have growth aspirations and that are investing. The Government is also concerned that the integrity of the tax system is undermined when the incentives are perceived to result in unfairness.

Consultation

1.11 As mentioned above, the Government issued a discussion paper alongside PBR 2004 to gauge the views of business on how the tax and incentive structure should operate. At Budget 2005 it was announced that the closing date for responses to the discussion paper would be 29 April 2005. By that stage more than 30 responses had been received including from the Confederation of British Industry, Federation of Small Businesses, Small Business Service, and others. Officials in both HM Revenue and Customs and HM Treasury have continued to engage in informal dialogue with business representatives.

1.12 The responses to the discussion paper raised a wide range of issues, but there was no consensus on future developments. The key issues raised were the need for simplicity and certainty in the taxation of small business.

1.13 At PBR 2005 the Government announced their intention to remove the zero per cent starting rate of corporation tax and the NCDR (option 3 below). A partial RIA was published, inviting comments particularly on the compliance costs of the starting rate and NCDR.

Options

1.14 Three options have been considered to simplify the corporation tax structure for small companies. **All changes would be effective from 1 April 2006.**

1. Do Nothing

1.15 If no changes are made, the number of the incorporations who benefit from the starting rate incentive for growth, but who are not intending to grow, would increase and the compliance costs identified by small companies in administering the NCDR would remain.

2. Remove the NCDR and leave the Starting Rate of Corporation Tax in place

1.16 This option would return the corporation tax structure to that which existed before the introduction of the NCDR in 2004. Although this would achieve a simplification of the structure, it would not improve the focusing of incentives on small companies intending to grow. There is also a large risk that further incorporations would take place by businesses which did not intend to retain and reinvest their profits for growth – thus increasing the unfairness of businesses exploiting the incentives simply to reduce their tax and NICs liability.

3. Remove both the NCDR and Starting Rate of Corporation Tax and provide Direct Incentives for Growth

1.17 Removing both the NCDR and the starting rate, and replacing them with a single small companies' rate, would achieve significant simplification of the corporation tax structure for small companies. It would also mean that companies with profits of less than £50,000 per year could have a tax increase, depending on their current profit distribution policy.

1.18 The corporation tax incentive to retain profits would be removed, so the Government proposes to focus incentives better so that both companies and sole-traders/partnerships can benefit more directly when they reinvest, rather than just retain their profits. The first year capital allowances available to small businesses will be increased from the current level of 40 per cent to 50 per cent for investment in plant and machinery made in the year from April 2006.

Costs and Benefits

Sectors and Groups Affected

1.19 Companies in all sectors are potentially affected. The impact will vary by profit level. The table below shows the number of companies affected, broken down by sector.

Table 1.1 Number of companies affected, broken down by sector

Sector	Number
Agriculture and Mining	10,500
Manufacturing	43,500
Technology	69,000
Utilities	500
Construction	72,500
Transport	34,500
Wholesale and Retail	64,000
Hotels, Bars and Catering	23,500
Finance and Real Estate	61,500
Business Services	221,000
Entertainment and Personal Care	61,000
Other	31,500
Not Known	27,000
Total	720,000

Financial Impacts

1.20 Each option would result in different amounts of overall tax (and NICs) paid to the Exchequer by small businesses depending on the legal form they adopt and hence the rates of tax (and NICs) due. The overall impact would also be affected by the numbers of businesses that incorporated because they thought they could gain a tax advantage by doing so.

1.21 The financial impacts would vary according to the profit level of the company. For example, a small company which made £20,000 per year from which it paid a salary to its owner manager of £10,000: under option 1, if its remaining profits (£10,000) were retained in the company then the company would pay no corporation tax (the zero per cent rate). If its profits were distributed they would be subject to the 19 per cent NCDR. The same company under option 2 would pay no tax (the zero per cent rate), whether its profits were retained in the company or distributed. Under option 3, it would pay the 19 per cent corporation tax whether its profits were retained in the company or distributed.

1.22 Another company with profits between £10,000 and £50,000 would be liable at the 19 per cent small companies' rate of corporation tax under option 1, with a reduction for marginal relief. If the profits were distributed, the company would, through the NCDR, pay tax at 19 per cent. The same company in the marginal relief band would under option 2 only pay the corporation tax with marginal relief. Under option 3 it would pay a single rate of 19 per cent corporation tax.

1.23 In total we estimate that 720,000 companies have profits under £50,000 per annum and so would be impacted by all options. This figure has been reduced from 820,000 in the partial RIA due to new and better company data. The amount of tax they would pay under each option depends on their profit level and whether or not they already paid NCDR. Not all companies who are liable to NCDR will have filed returns yet so detailed information is not available on the number already paying NCDR who would see little or no increase in tax under option 3. We estimate that the median tax increase for all companies under that option would be around £475 per year.

1.24 The benefit to businesses of the first year capital allowance under option 3 depends on their level of profits and legal form. For example a small company making a £1,000 investment in plant and machinery would gain £19 on profits taxed at 19 per cent and £30 where profits were taxed at 30 per cent. Around 4,200,000 small businesses would be eligible for the increased allowance as it is available to sole traders/partnerships as well as companies.

Compliance Costs

1. Do Nothing

1.25 The compliance costs identified by small companies in administering the NCDR – through identifying non-corporate dividends and calculating the NCDR – would remain. The RIA for the NCDR published in April 2004 estimated only a modest increase on the then existing compliance costs. However, discussions with small businesses and their representatives since publication of the discussion paper indicate that the compliance costs related to implementation of the NCDR were significantly greater than originally estimated.

1.26 Compliance costs are created because a company has to calculate the corporation tax which would be due if the NCDR did not exist, and thus establish the underlying rate of tax; establish the amount distributed through dividends to persons other than companies; apply the NCDR rate to that amount of non-corporate dividend; and apply an underlying rate to the balance of taxable profits. The partial RIA estimated these compliance costs to be in the region of £35 million per year. Responses to the partial RIA suggested that this figure over-estimated the time taken to complete the NCDR calculation. The figure on the number of companies affected by the NCDR has also been revised downwards to 310,000. The compliance costs associated with the NCDR are therefore calculated to be £23 million per year, assuming the total compliance time for a company to be 1.5 hours and that their time costs £50 per hour.

2. Remove the NCDR and leave the Starting Rate of Corporation Tax in place

1.27 Removal of the NCDR would provide deregulatory benefits to companies with profits below £50,000 per year as they would not be required to calculate the NCDR. Some complexity would remain for companies with profits between £10,000 and £50,000 through having to calculate marginal relief on their corporation tax. The partial RIA estimated the cost of this complexity to be in the region of £10 million per year. As the number of companies affected has since then been revised downwards to 720,000, it is now calculated that the cost is £9 million, assuming it takes 0.25 hours at £50 an hour to calculate the marginal relief on their corporation tax.

3. Remove both the NCDR and Starting Rate of Corporation Tax and provide Direct Incentives for Growth

1.28 There would be significant deregulatory benefits obtained through the removal of the NCDR for companies with profits below £50,000 per year and the starting rate of corporation tax. As described above, it is estimated that this saving to business would be £23 million per year from removing the NCDR and £9 million from removing the starting rate. However, there would be a small additional cost for any companies with profits below £10,000 who are not currently distributing profits and so not liable for the NCDR.

1.29 In due course HMRC will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

Small Firms Impact Test

1.30 We estimate that nearly all of the impacts mentioned above will be on small and medium sized businesses. Corporation tax rates are based on profit levels not size of business, but at the level below £50,000 there is a strong correlation.

1.31 The Government will continue to seek the views of small businesses and their representatives on developments in the corporation tax structure and incentives for growth.

Competition Assessment

1.32 The competition filter test has been applied to this measure and no significant competition concerns have been identified.

1.33 The vast majority of firms affected by the change are small businesses that do not have any significant market share. The taxation paid by companies under the options would vary between companies, but the compliance costs would not. Simplification of the corporation tax structure will lead to lower ongoing compliance costs for new and existing companies.

1.34 Option 3 would help to level the competitive playing field as the incentives for growth would be available to all small businesses, in contrast to the zero per cent starting rate which was only available to companies.

Enforcement, Sanctions and Monitoring

1.35 Under option 1, the enforcement and monitoring costs from the NCDR as currently operated would continue. Options 2 and 3 would remove those costs.

1.36 Enforcement of compliance with the corporation tax regime generally is an integral part of HM Revenue and Customs administration of the UK tax system. Monitoring trends in re-investment by small businesses to determine where incentives may be best focussed is an ongoing activity of HM Treasury.

Summary and Recommendation

1.37 Taking account of the costs and benefits of the different options the Government takes the view that removing the NCDR and starting rate of corporation tax and increasing first year capital allowances to 50 per cent best meets the objective to better focus tax incentives for re-investment and to reduce administrative burdens on business by simplifying the corporation tax system.

Implementation and Delivery Plan

1.38 The removal of the NCDR and starting rate of corporation tax is a deregulatory measure and will simplify the corporation tax system for small companies. There will be no extra obligations on companies or requirements for data because of the measure.

1.39 The company tax return form and accompanying guide will be amended and new copies should be available in October 2006. Companies will have time to adjust to the new measure as the filing date for corporation tax is one year after the end of an accounting period. The earliest accounting period affected by the removal of the NCDR and starting rate of corporation tax will be that ending 1 April 2006. The filing date for this accounting period will be 1 April 2007. Guidance will be provided for all companies with accounting periods ending on or after 1 April 2006 so that companies affected by the changes and wanting to deliver their returns early can do so.

1.40 The guidance on the change will be provided for both small companies and their advisors. A Budget Insert giving advice, and describing the changes to company tax return forms and CT Online services, will be sent out with notices to deliver a company tax return. Paper copies of the Insert will be available from the order line. Further guidance will be published on the internet.

1.41 Neither the record keeping and business information requirements for the company tax return, nor the process for delivering returns, is affected by this measure.

1.42 The measure will also provide deregulatory benefits for Government because of the simplification of the corporation tax system. However, there will be a one-off cost from system changes, for example through changes to the company tax return form.

Post-implementation Review

1.43 The Government's objective is to simplify the corporation tax system and to better focus tax incentives for re-investment. They will monitor the impact of corporation tax simplification to assess whether further measures are necessary and monitor the take-up of first year capital allowances to assess the effectiveness of re-investment incentives.

I.44 The Government will continue to review the structure of the taxation systems to ensure that they are as simple as possible for compliant businesses, support businesses in their aspirations to grow, and maintain the overall competitiveness of UK business taxes.

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REGULATORY IMPACT ASSESSMENT

Changes to the Corporation Tax Structure

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:

John Healey
Financial Secretary to the Treasury

Dated: 16 March 2006