Retention of profits by small firms

Standard Note: SN/BT/395
Last updated: 12 February 2004
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The owners of small firms trading as unincorporated businesses are subject to income tax on the trading profits of the business. Small firms trading as limited companies are subject to corporation tax on their trading profits. The small business community has argued that the tax system favours incorporated businesses and these criticisms have grown with the introduction of a starting rate of corporation tax in April 2000 on taxable profits up to £10,000 – cut from 10 per cent to 0 per cent in the 2002 Budget.[1] Some have argued that to compensate for the fiscal advantages of incorporation, tax relief should be given to encourage unincorporated businesses to retain their profits for reinvestment – although governments of both parties have opposed such a measure. This note gives a short history of this proposal.

The wider debate about the impact of the new starting rate of corporation tax on the decision to incorporate is discussed in a second Library note,[2] which also discusses the Chancellor's announcement – in the 2003 *Pre-Budget Report* – that the Government would bring forward proposals in the 2004 Budget "to ensure that the right amount of tax is paid by owner managers of small incorporated businesses on the profits extracted from their company."[3]

The proposal that unincorporated businesses should be given tax relief for retained profits has quite a long history. For example, in evidence to the Trade and Industry Committee as part of its inquiry in the 1994-95 Session into the small business sector,[4] both the Federation of Small Businesses (FSB) and the Birmingham Chamber of Commerce and Industry suggested that business profits should be charged a lower rate of tax if retained for reinvestment. The FSB noted that incorporated firms usually paid corporation tax on profits at the main rate, then 33%, whereas unincorporated firms would pay at the proprietor's rate of income tax - up to the higher rate of 40% - whether or not the profits were reinvested.[5] The FSB argued that retained profits should be charged tax at a small business rate of 25% on profits up to £300,000 to "bring to the taxation of sole traders more into line with that of small incorporated companies"[6] while the Birmingham Chamber of Commerce suggested that retained earnings up to £200,000 for both incorporated and unincorporated businesses should be tax-free.[7]

1 Inland Revenue/HM Customs & Excise Budget press notice REV/C&E 2, 17 April 2002
2 "Owner-managers of small companies ('IR 591')", Library standard note SN/BT/2905, 12 April 2003
3 Cm 6042 December 2003 para 5.91
4 *The Small Business Sector*, 5 July 1995 HC 194 1994-95
5 Rates of corporation tax over the last thirty years are given on the Revenue's internet site at: http://www.inlandrevenue.gov.uk/stats/corporate_tax/00ap_a6.htm
6 HC 194 1994-95 p 3
7 HC 194 1994-95 p 69

A key difficulty with this proposal is the question whether earnings should be earmarked in some way to attract relief - a complex and possibly costly procedure -, or, if not, whether a general tax relief would simply result in a deadweight loss: businesses increasing their savings rather than their investment activity.[8] The Inland Revenue submitted a critical memorandum to the Committee arguing that such a scheme would "only benefit those least in need of help, ie those who could afford to leave their profits in their business or indulge in avoidance."[9] The Committee was more sympathetic to the principle of using tax relief to small firms to retain their profits, and recommended that the Treasury should re-examine ways of doing this.[10]

In its response to the Committee's report the then Conservative Government did not commit itself on the matter,[11] though the proposal remained popular in the business community. In March 1996 the *Your Business Matters* consultation exercise – a series of one day conferences for small businesses organised by, amongst others, the CBI, the Institute of Directors, and the Forum of Private Business – found that one of the top ten priorities for government action among participants was a new relief for retained profits, to match the fiscal incentives provided by tax-privileged savings schemes and pension funds.[12] The Government was unenthusiastic in its response, simply stating that it was "guided by the belief that the best way of encouraging small business owners to reinvest profits in their own businesses is to cut taxes on profits, gains and inheritance."[13]

The issue arose during the scrutiny of the Finance Bill the next year, when the then Financial Secretary, Michael Jack, argued this type of relief would, at best, reward the most profitable businesses, doing nothing to help those in financial difficulties:

> I have looked briefly at the representations made by the Federation of Small Businesses on the proposal for tax reliefs. There are practical problems with it. In the real world, that proposal is most likely to be valuable to an already profitable company. By definition, that does not solve the difficulties of the others. There is also a question of whether businesses would fragment if there were some kind of exemption activity by trying to create tax-relieved areas of activity. I do not want to go into detail on that, but questions such as that are being raised. Finally, would we create the possibility of a system of untargeted tax reliefs, raising the question of whether the funds would necessarily be used for the business purpose that the hon. Member for Dudley, West intends?[14] We take this subject seriously and are trying to deal with profitability and the ability to use profits for investment, but some of the

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8 "Retained earnings back on the menu", *Financial Times*, 14 February 1995

9 HC 194 pp 60-62

10 HC 194 p xiv In the summary of recommendations in the report, this was number 6 (p xxv).

11 "The Government notes the point made by the Committee. Decisions on taxation policy are for the Chancellor to make in his Budget. The Government keeps proposals of this kind under regular review." (Trade and Industry Committee, 1 November 1995 HC 821 1994-95 p vii).

12 Institute of Directors, *Your Business Matters - Report from the Regional Conferences*, 1 March 1996 p 7

13 Department of Trade and Industry, *Your Business Matters*, 1 June 1996 p 15

14 Ian Pearson MP had asked the Minister what the Government's response was to the Select Committee's recommendation on retained profits.

> ideas put forward are useful debating points rather than alternatives to the current system.[15]

Following the 1997 General Election the Labour Government showed the same lack of interest in the proposal, as a written answer given in July 1998 showed:

> **Mr. Gale:** To ask the Chancellor of the Exchequer what proposals he has to stimulate investment in and expansion of small business; what consideration he has given to allowing the retention of profits for the purpose of investment in and the expansion of small businesses; and if he will make a statement.
>
> **Mr. Byers:** The Government announced in the Comprehensive Spending Review that they will refocus business support programmes to promote innovation and enterprise, with a particular emphasis on small and medium-sized enterprises that have the potential for high growth. The Government said in the last Budget that they will continue to examine how best to create an environment which encourages investment by small and medium-sized businesses. This includes reviewing the case for continuing with enhanced capital allowances.[16]

The FSB has continued to petition for this type of tax relief – for example, in evidence to the Trade and Industry Committee in 1998[17] and in their Budget submission in spring 2000. In the latter case the Federation suggested that business owners should be entitled to transfer profits for reinvestment to a tax-protected savings account, and that any withdrawals for 'non-business' purposes would be subject to tax in the normal way.[18]

In its 1998 report on SMEs the Committee recommended that "the Government must explore all options, including fiscal incentives and reforms, to ensure the development of a UK capital market able to meet the demands for finance of SMEs",[19] though it does not appear to have returned to the proposal for tax relief on retained profits. In February 2003 the FSB published a report proposing that all businesses – both incorporated and unincorporated – should enjoy a £10,000 tax free allowance to 'level the playing field.'[20] The report is strongly suspicious of the introduction of a zero rate of corporation tax announced in the April 2002 Budget, and suggests this is part of a 'wider agenda' on the part of the Government "to ensure a more closely regulated small business sector and greater government control."[21]

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15 SC Deb (B) 18 February 1997 c 396

16 HC Deb 31 July 1998 c 655W

17 "Appendix 1 : Memorandum submitted by the Federation of Small Businesses", *Small and medium sized enterprises*, 9 June 1998 HC 774 1997-98 p 12 The FSB also made this argument in its 1999 *Budget Submission*, October 1998 pp 13-15

18 FSB, *Budget submission*, March 2000 para 3.2.2

19 HC 774 p xiii

20 In the case of unincorporated businesses, this would be in addition to the personal tax allowance. For details see FSB, *The self employed versus incorporated businesses*, February 2002 p 3. At present this is on the Federation's site at: www.fsb.org.uk/policy/archivepubs/assets/Self_Employment.pdf

21 FSB press notice, *Self employed pay 32 times more tax than incorporated businesses*, 3 February 2003