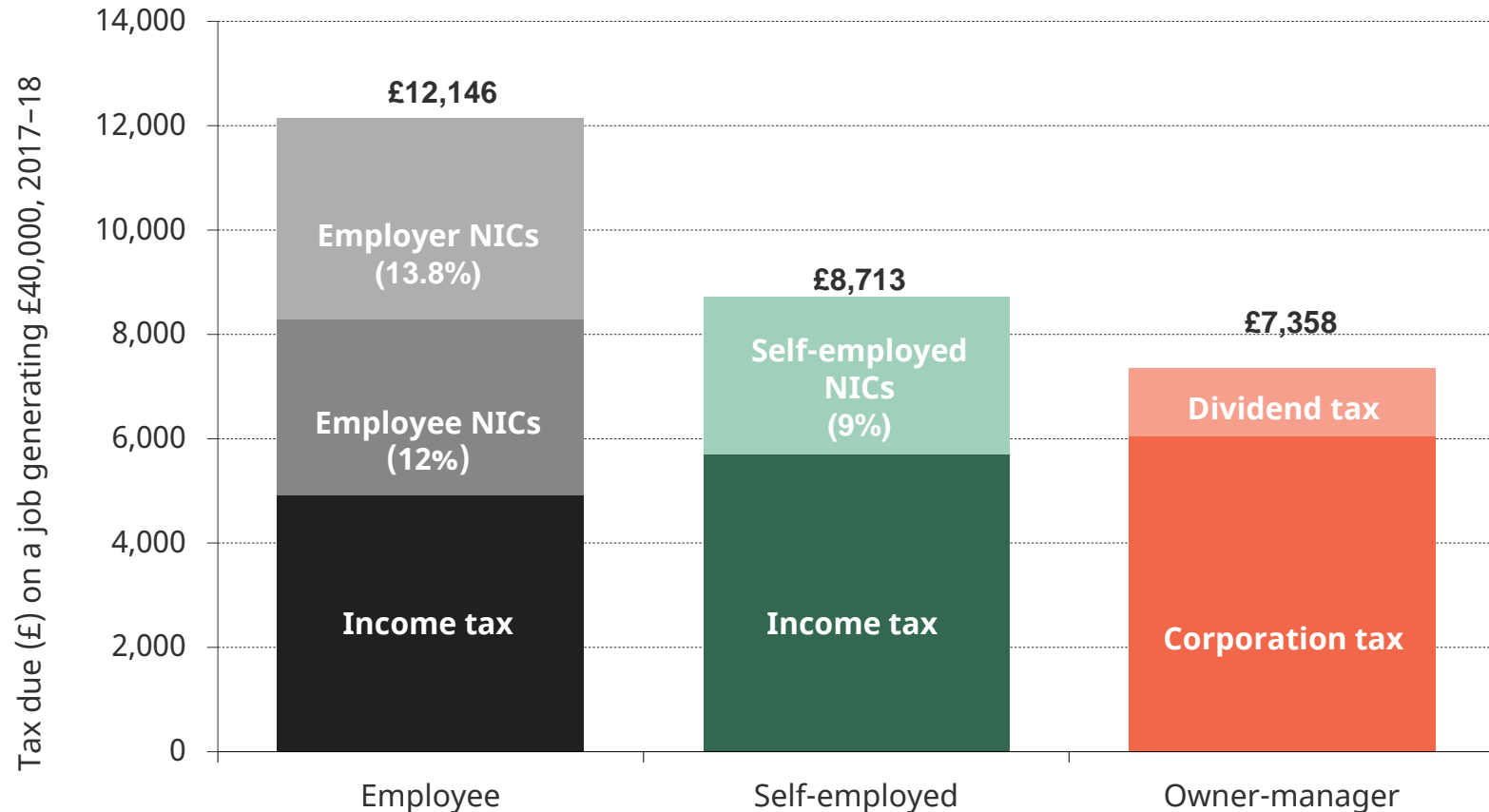


# How do small business owners respond to the tax system?

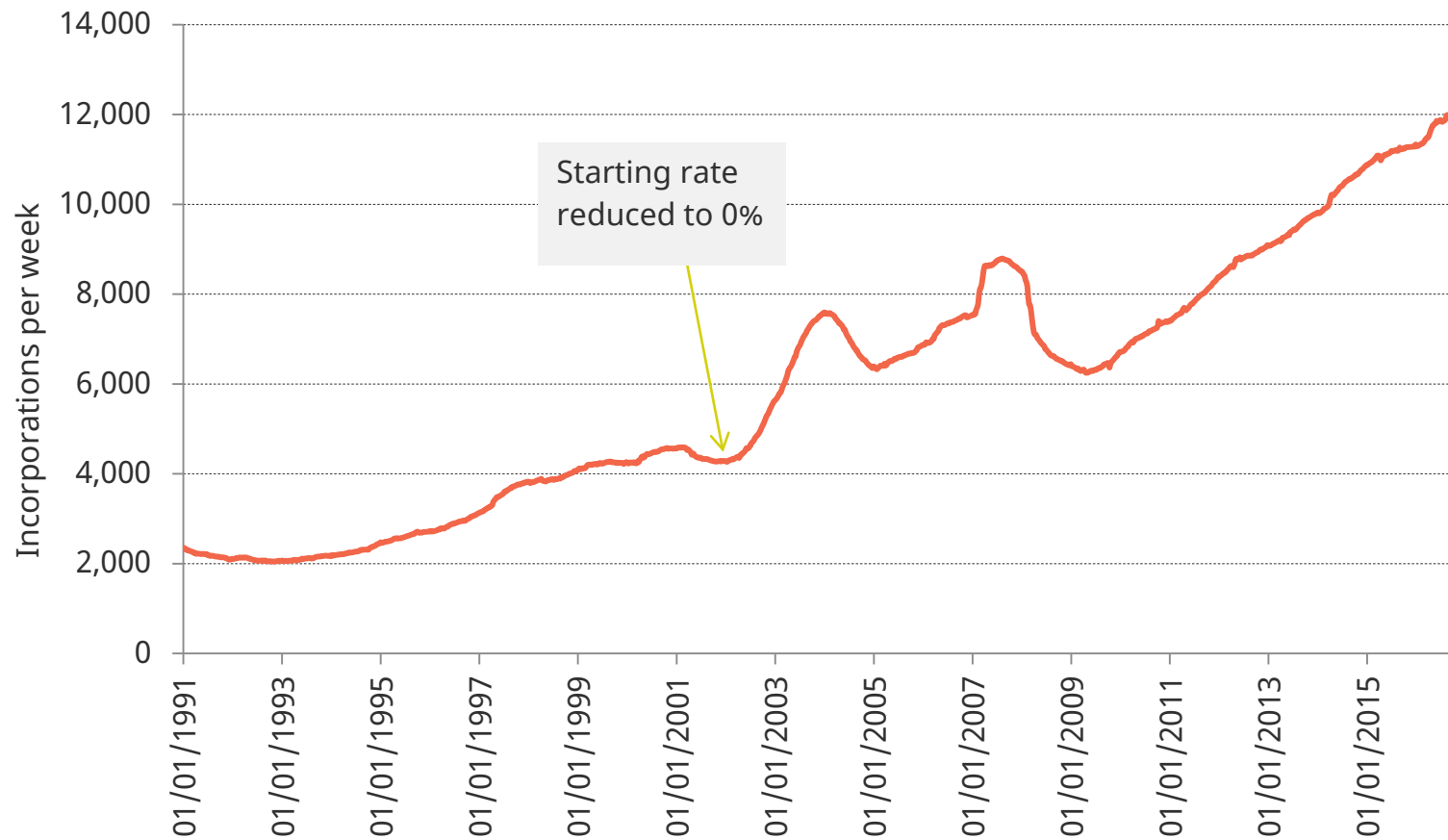
**Kate Smith**

# The tax system favours business ownership



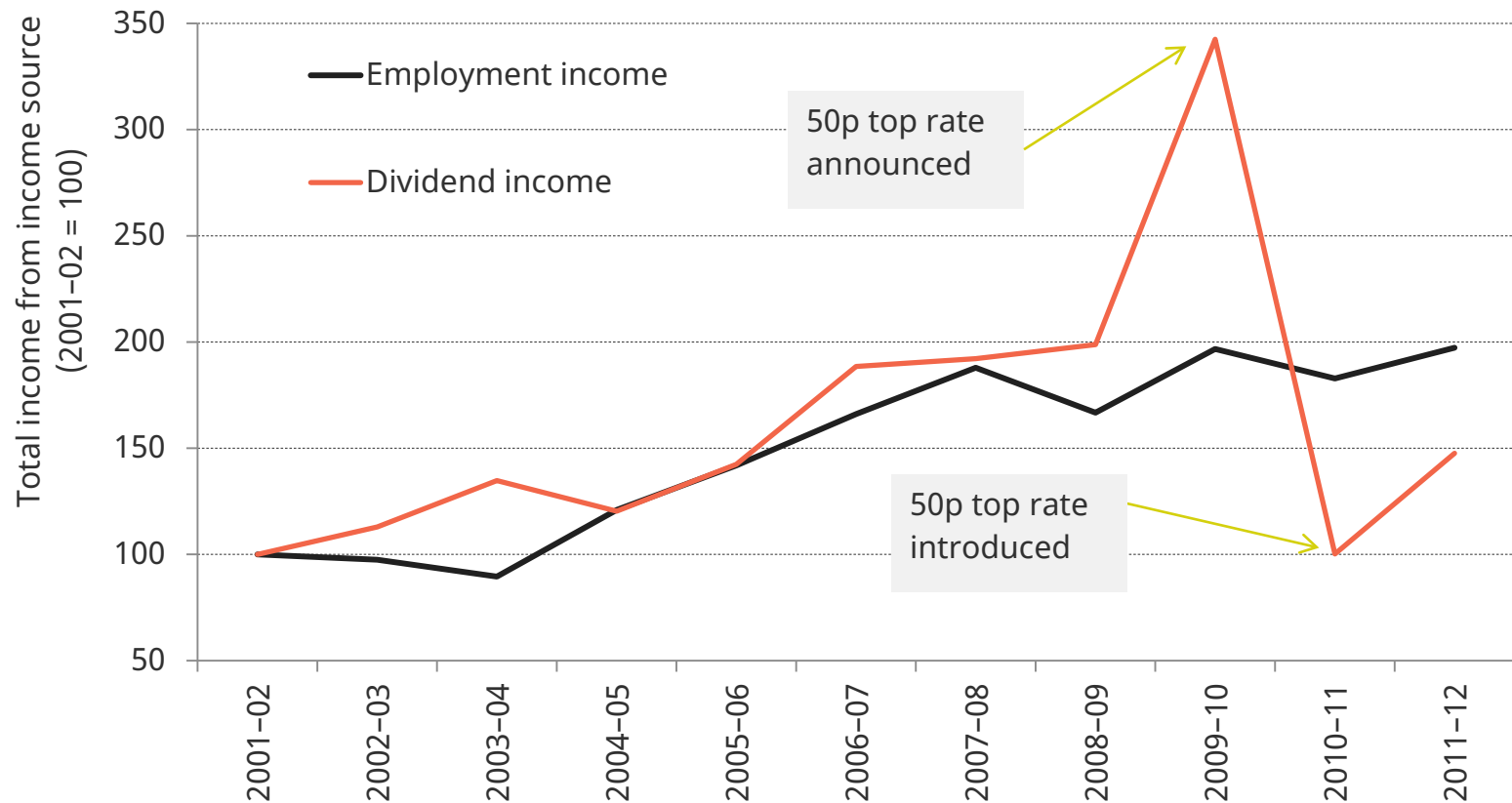
Notes: Income tax is slightly higher for the self-employed than for employees in this chart only because the latter are charged income tax on income *net* of Employer NICs.

# People move between organisational forms



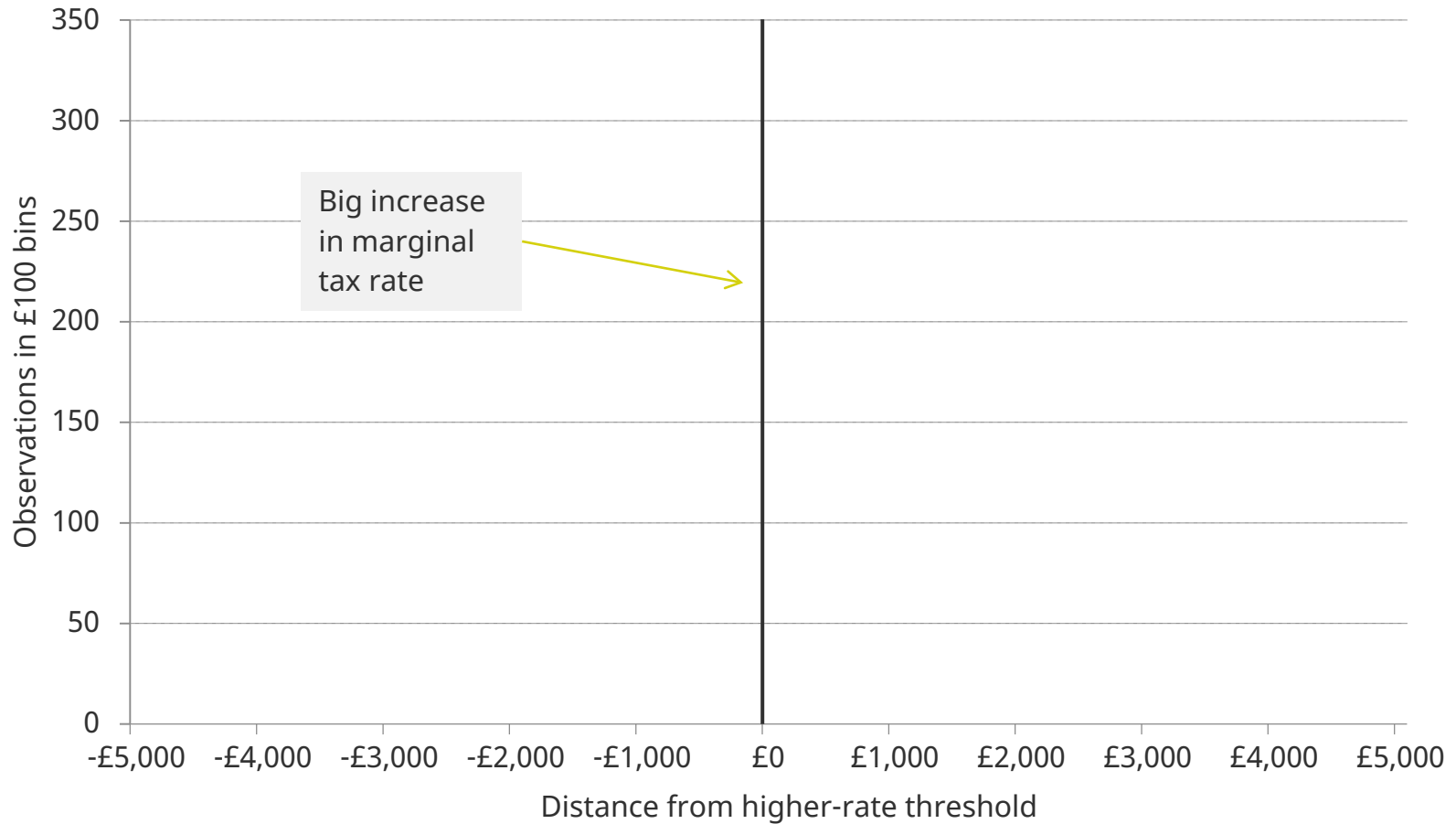
Source: Figure 7.6 in Chapter 7 "Tax, legal form and the gig economy", *The IFS Green Budget*, February 2017 .

# People shift income when the tax system changes



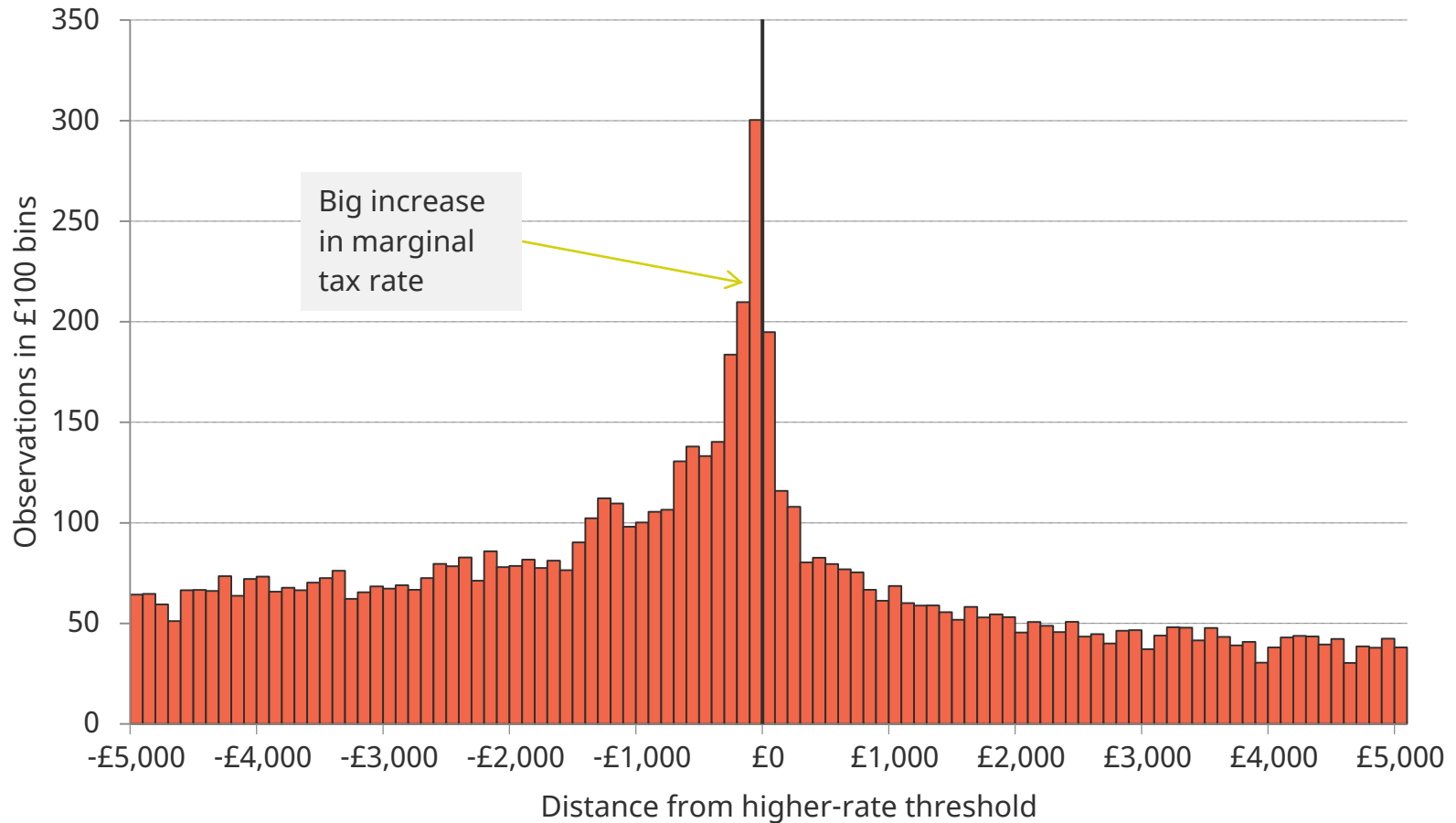
Notes: More individuals had to file tax returns in 2010-11, leading to slightly understated income falls in that year.

# Owner managers bunch at kinks in the tax schedule



Notes: Distance from higher-rate threshold measured in 2007–08 prices. Distribution shown for company owner-managers, 2003–4 to 2007–8.

# Owner managers bunch at kinks in the tax schedule



Notes: Distance from higher-rate threshold measured in 2007-08 prices. Distribution shown for company owner-managers, 2003-4 to 2007-8.

# Company owner-managers have a lot of flexibility over when to withdraw income

## Individuals with incomes that fluctuate around a kink point have an incentive to smooth taxable income over time

- By bunching at the kink point they can ensure they don't pay the higher rate of tax in 'good years'

## Individuals with average incomes above the higher rate threshold have an incentive to retain profits until company liquidation

- Entrepreneur's Relief: lower capital gains tax rate paid on business income taken out on liquidation

## Adjustment of real activity is not the only way to bunch

# New linked tax records crucial to get fuller picture of owner-managers' behaviour

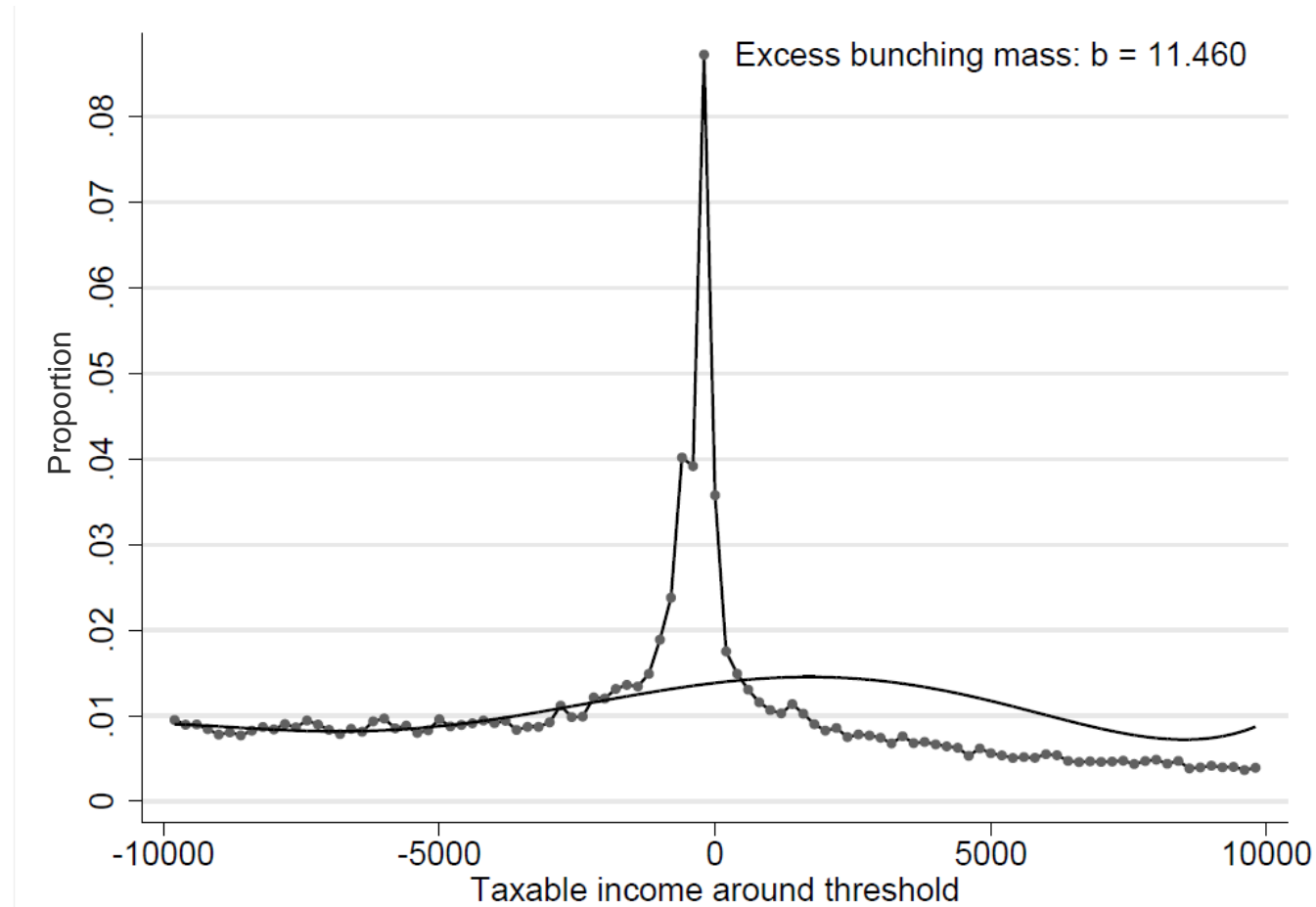
## New link between personal tax records of the owner-manager and the corporate tax records of the company

- Observe: company profit (total income), and timing and size of taxable income withdrawals by owner-manager

**Allows us to understand how much of responsiveness is driven by income shifting or adjustments to 'real business activity'**

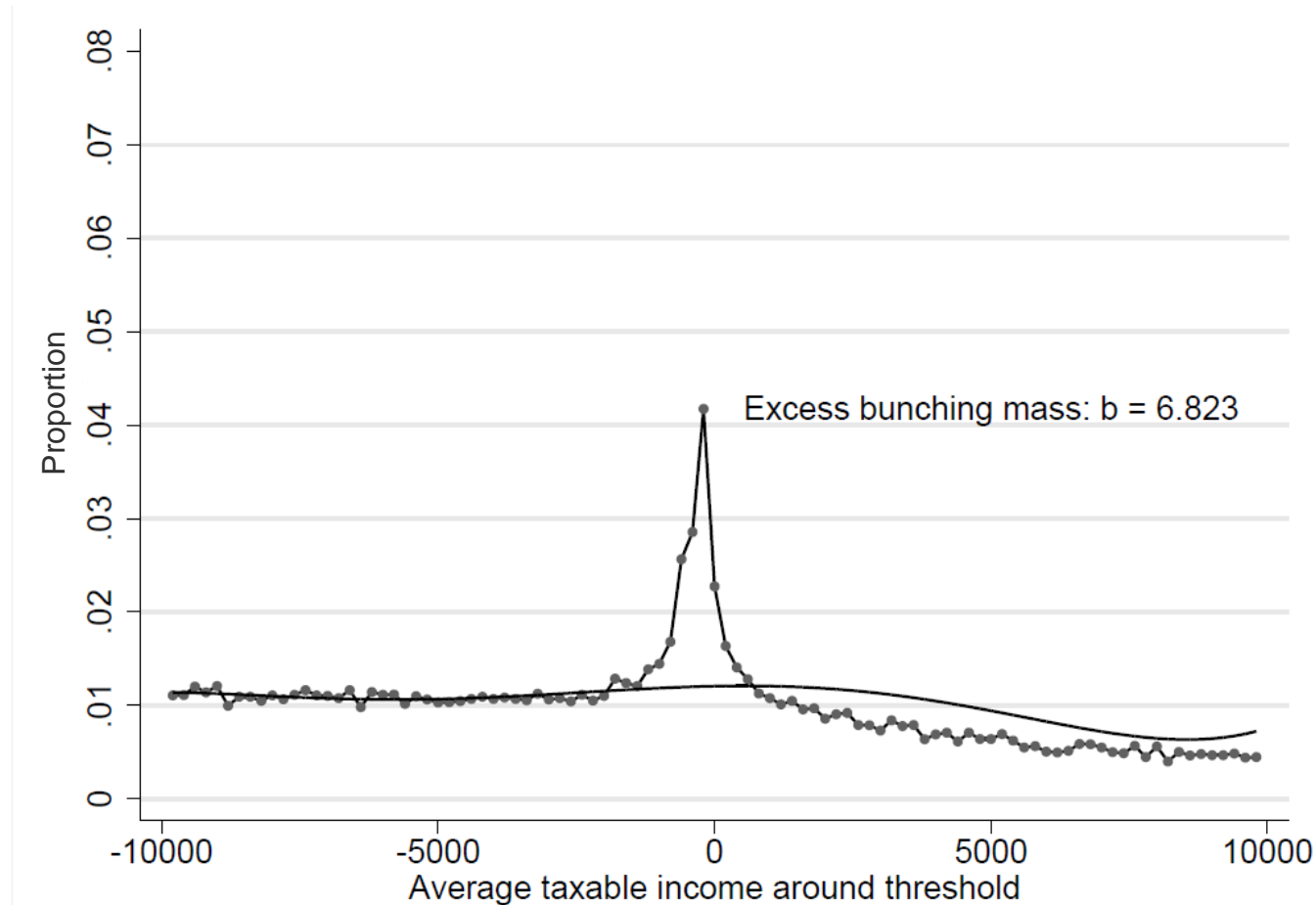


# Bunching in annual taxable income - all responders



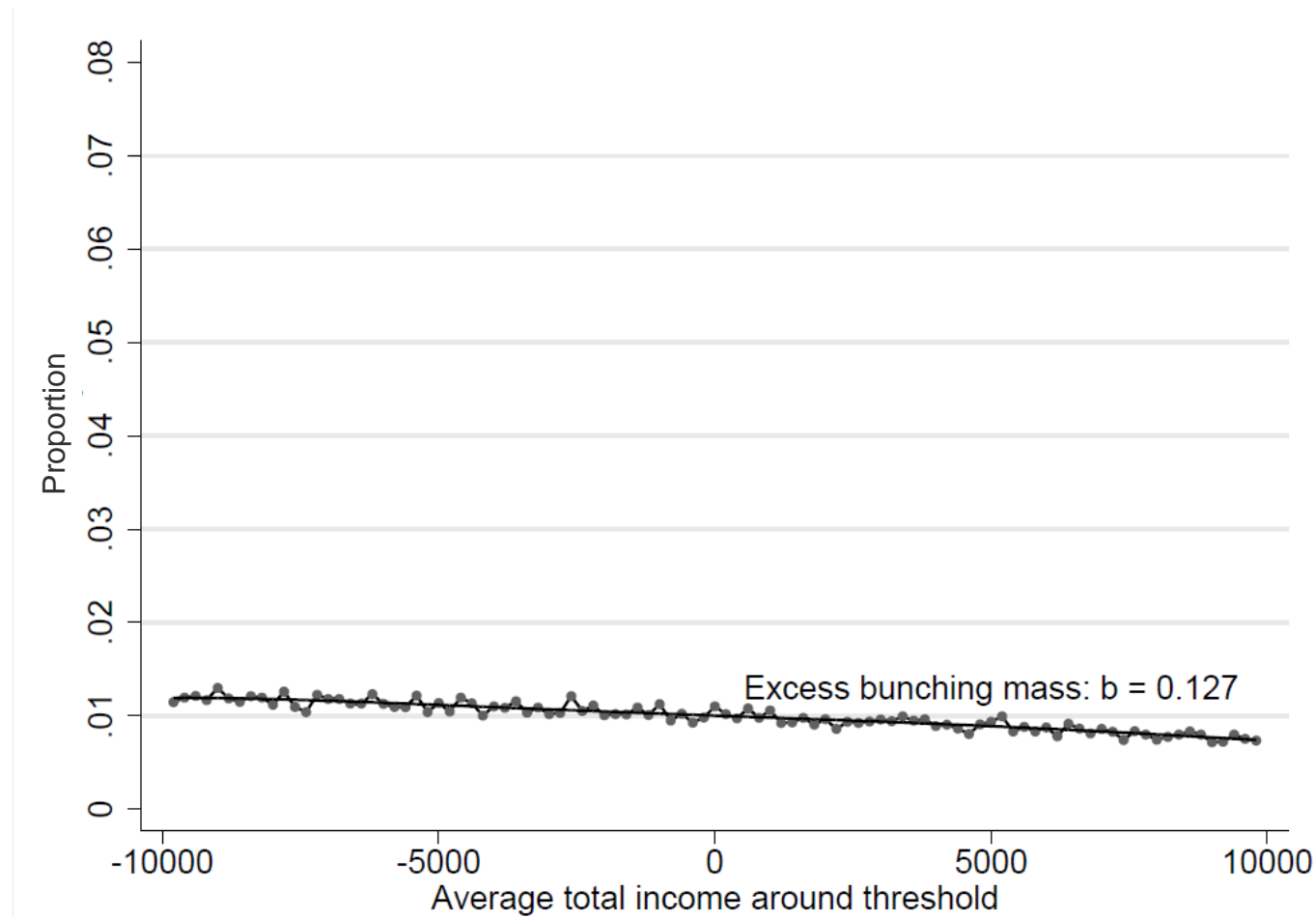
Notes: Authors' calculations using HMRC administrative tax records. Bin width is £100. Counterfactual density estimated using higher order polynomial.

# Bunching in average taxable income – takes out short term income shifters



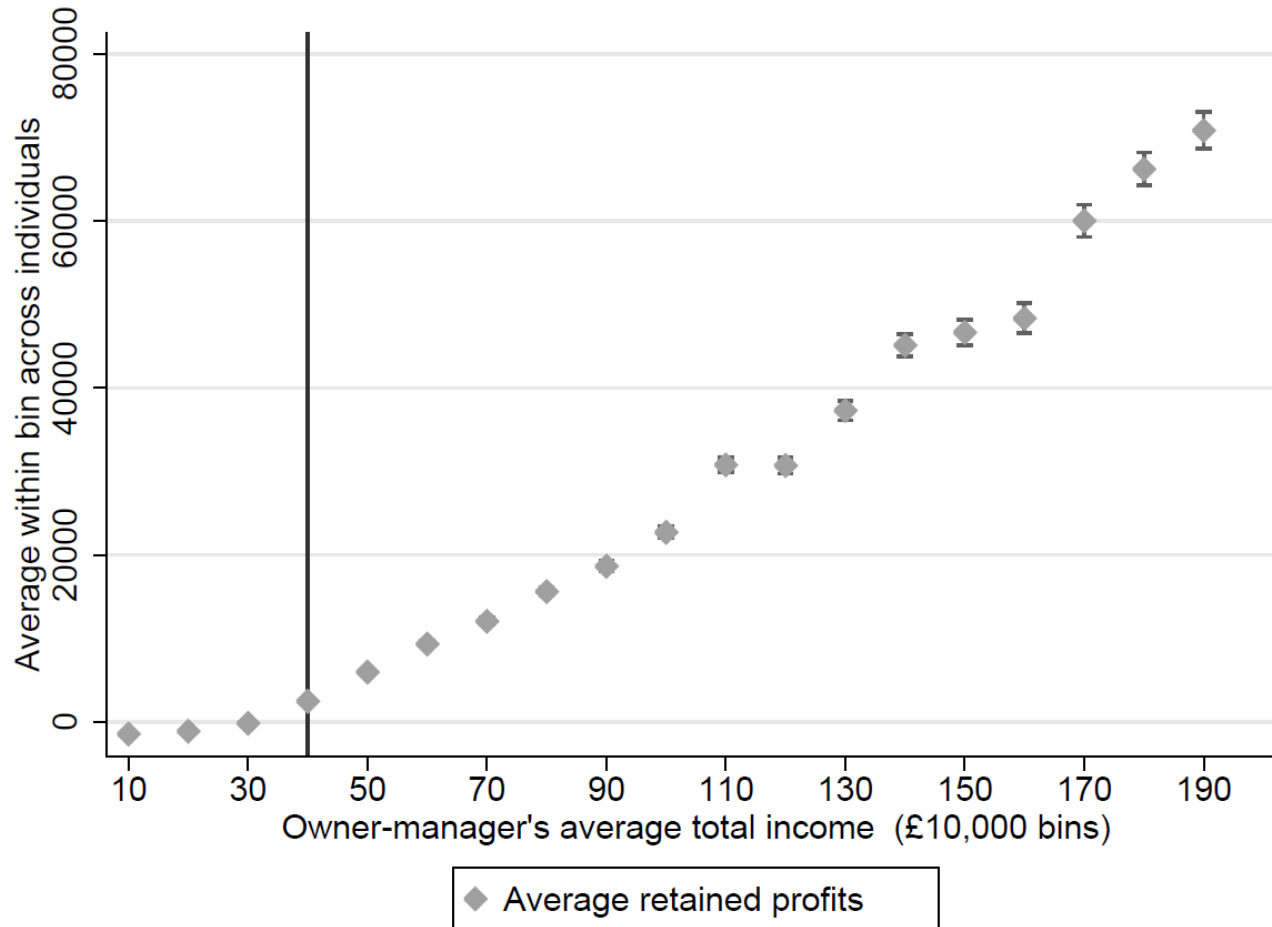
Notes: Authors' calculations using HMRC administrative tax records. Bin width is £100. Counterfactual density estimated using higher order polynomial.

# Bunching in average total income – takes out longer term income shifters



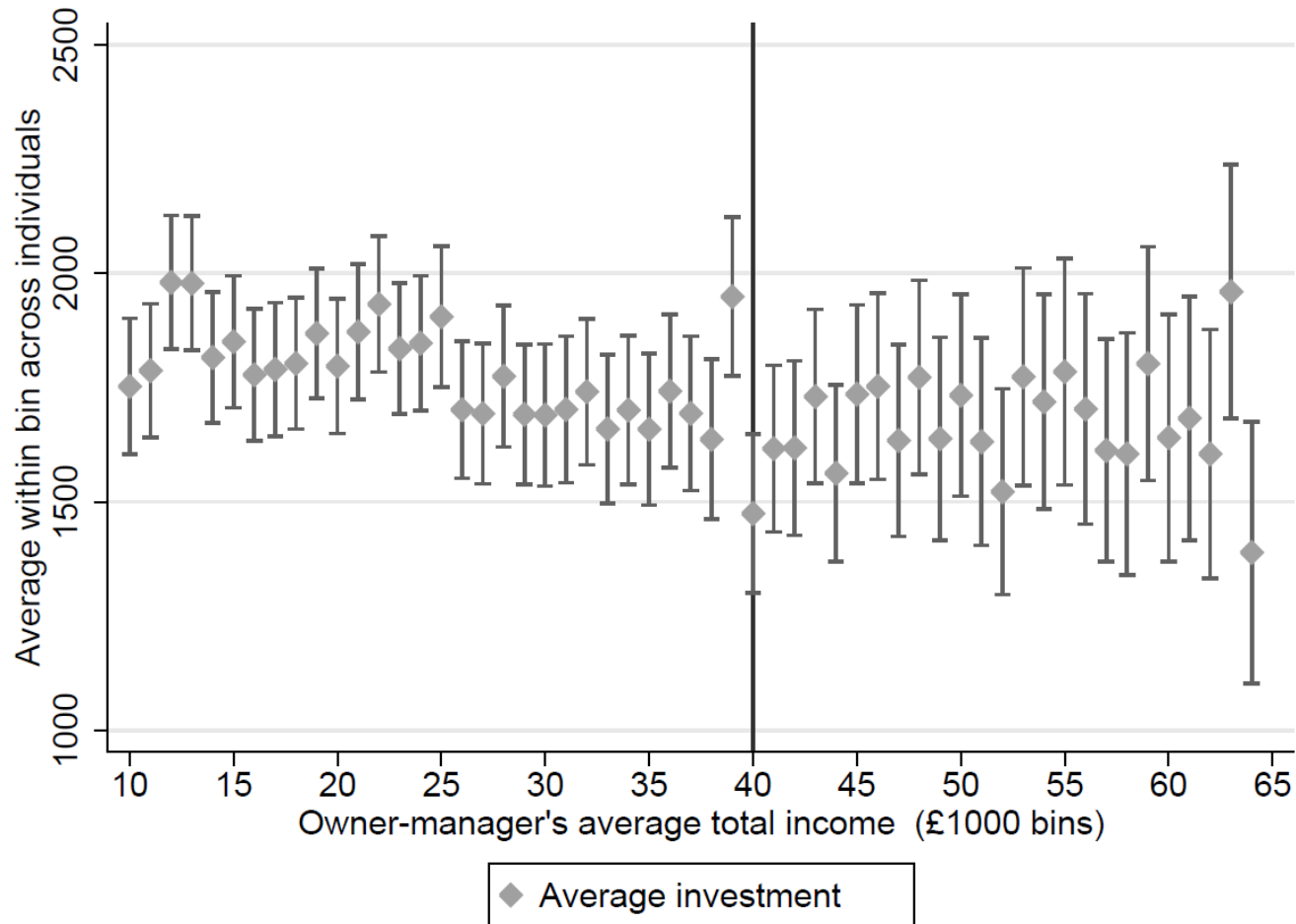
Notes: Authors' calculations using HMRC administrative tax records. Bin width is £100. Counterfactual density estimated using higher order polynomial.

# Retained profits are important, particularly for higher income owner-managers



Notes: Authors' calculations using HMRC administrative tax records. Average retained profits constructed across years observed for each owner-manager.

# No evidence that investment is higher for those retaining profits above threshold



Notes: Authors' calculations using HMRC administrative tax records. Average investment constructed across years observed for each owner-manager.

# Conclusion – responses matter

## Business owners are very responsive to the tax system

- They have flexibility over how and when to take their income
- And use this to respond to changes in the tax rates they face
- We find intertemporal income shifting explains bunching at thresholds

## Understanding *how* these individuals respond is crucial

- Short term shifting: gives individuals with volatile income ability to smooth
- Longer term shifting:
  - Distorts choices and reduces government revenues
  - We find no evidence that retained profits are linked to higher investment