Income Tax and Small Businesses in Scotland

Federation of Small Businesses Scotland
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Key Points

- The extent to which small businesses and their owners might be affected by changes to Scottish rates of income tax depends upon their sources of income and, specifically, whether the business is incorporated or unincorporated.

- The income tax landscape in Scotland is already complex because of the interactions between rates, reliefs, social security and other taxes – National Insurance payments, for example. Further change to rates and bands in Scotland will mean an even more complex system.

- Just under half of our members (44.4%) might be affected by Scottish rates of income tax because they are unincorporated, while the majority (53.7%) are incorporated and therefore likely to pay UK rates on dividends or corporation tax.

- Most FSB members are basic rate taxpayers, though around a quarter are higher or additional rate payers. Of those running unincorporated businesses, around two thirds are paying the basic rate while just under fifth (18%) are higher or additional rate payers.

- The majority of our members (58.3%) think income tax rates in Scotland should remain unchanged. Around a fifth think they should be decreased and another fifth think they should be increased.

- Nearly two thirds (65%) also believe that increases to income tax would have a negative impact on business and the economy. However, just under a fifth felt it would be beneficial to the economy to increase income tax, while a similar number felt it would make no difference.

- When asked to consider the four options for change suggested by the Scottish Government, our members’ preferred approach was the most radical option. This approach creates six rates to reflect a broader spectrum of incomes.
Introduction

In 2017 the Scottish Parliament assumed new powers over income tax. While the UK Parliament remains in charge of certain key aspects of the tax, such as reliefs, the Scottish Parliament gained control of setting rates and bands of income tax. While this led to limited change for the current financial year, speculation has subsequently increased that the Scottish Government may consider more substantial change to income tax for the 2018-19 Scottish Budget. In early November 2017 the Scottish Government published a discussion paper examining the role of income tax in the Scottish budget. This paper includes options for change, as well as key tests, such as protecting public finances and avoiding harm to the economy, against which the government would measure any proposals.

Ahead of last year’s Scottish Budget, we suggested that with so much economic uncertainty, income tax rates should be kept the same as the UK. However, at that point limited evidence was available about the impact of change on smaller businesses, with most analysis considering the impact of change on the highest earners. Such analysis commonly discusses the potential for entrepreneurs to be deterred from doing business in Scotland, were taxes to be increased. Conversely, recent discussion about the self-employed has tended to focus on low incomes of those working for themselves. Neither of these scenarios adequately considers the circumstances of most small businesses.

Based on our work with FSB members ahead of the Scottish independence referendum in 2014, we know that small businesses’ views on big issues are influenced by a range of factors and may sometimes differ from the traditional corporate or big business view. Thus, ahead of this year’s Scottish Budget, we wanted to know more about the impact of income tax changes on small businesses and their views on potential change.

Understanding the implications of changes to income tax for businesses is complex, in part because of the interaction with other taxes and reliefs and the difficulty assessing behavioural change as a response to changes in tax rates. In particular, the rate of income tax paid by small business owners in Scotland will depend upon the nature of their taxable income. Scottish rates of income tax apply to income from salary, pension or rental income, whereas income from dividends and savings is taxed at UK rates. Similarly, unincorporated businesses (sole traders and partnerships), pay income tax on profits from their business, while incorporated firms pay corporation tax on such profits and income tax on salary or dividends drawn from the business. National Insurance is also paid on earned income.

Notwithstanding these complexities and the lack of relevant data sources, we conducted an online survey of our membership in November 2017 – immediately

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1 In our work ahead of the 2017-18 Scottish Budget we highlighted the complexities associated with changes to income tax in Scotland, such as the challenge that National Insurance thresholds rise in line with UK rates, leading to additional costs and a high marginal rate for certain Scottish taxpayers.
following the publication of the Scottish Government’s income tax discussion paper. This poll, which attracted over 300 responses, allows us to better understand the varied tax circumstances of small businesses and their views on income tax changes.

FSB is grateful for the technical advice and information provided by ICAS in the preparation of this survey and its analysis. ICAS has also produced a detailed report which considers the broader implications of devolved taxes and the complexities associated with Scottish rates of income tax.

Small Business Taxpayers

As discussed above, the income tax rate paid by small businesses, in particular whether they will be subject to Scottish rates, depends in large part upon whether the business is incorporated or unincorporated.

The majority of respondents to our survey (53.7%) run a limited company, and would subsequently pay corporation tax on profits from the business, while 29.7 per cent identify as a sole-trader and a further 14.7 per cent are running a partnership. The latter two groups would pay Scottish rates of income tax on profits from their business. In other words, the profits of the majority of smaller businesses may not be affected by changes to income tax in Scotland, though a significant minority will pay these rates.

Figure 1: What is the legal form of your business?

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2 The survey of FSB members was conducted online from 8 to 23 November 2017. 315 responses were received.
However, in line with a changing labour market, including the rise in self-employment and the portfolio career, many small businesses do not only derive income from their business. Instead, income can be drawn from a number of sources.

Our survey revealed that, while the majority (58.3%) do not have additional sources of income, four in ten (41.7%) business owners’ income is more complex and the extent to which Scottish rates of income tax apply to this income will vary. The most common sources of additional income are pensions, property and investments, however just under a fifth (18.9%) also have income from employment.

As well as understanding more about their sources of income, we also wanted to know which rate of tax small businesses currently pay and, in particular, the extent to which they might be affected by increases for higher earners.

In line with most Scottish taxpayers, our survey shows that the vast majority of small business owners are basic rate taxpayers. However, there are fewer business owners who don’t earn enough to pay income tax than in the general population and more are higher rate taxpayers.

**Figure 2: Based on your taxable income in the last financial year, which income tax band applies to you?**

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3 Our recent response to the Scottish Affairs Committee’s Sustainable Employment inquiry provides a small business perspective on changes in the labour market.

4 p11 of the Scottish Government’s discussion paper on income tax sets out the number and proportion of adults by their marginal tax rate.
Almost two thirds (64.8%) are currently basic rate taxpayers. Interestingly, of these, the majority (57.2%) earn above £24,000 – the Scottish Government’s estimated median earnings for 2018-19. This matters because the alternative options set out in the Scottish Government’s discussion paper include approaches which split the current basic rate to create a new, increased rate for those above median earnings. Were such an approach to be adopted, then the majority of small businesses would potentially be affected by this increase. To put this in context, the Scottish Government’s discussion paper suggests that were the basic rate increased by 1p, a taxpayer with an annual income of £30,000 would pay just under £200 in additional income tax.\(^5\)

However, looking only at unincorporated businesses (those most likely to be paying Scottish rates of income tax on their income) the figures are slightly different. A higher proportion are basic rate taxpayers (66.9%) and the majority have an income below the median, with 52.2 per cent earning below £24,000.

Only 11.1 per cent of respondents are paying no income tax due to their earnings being below the current personal allowance of £11,500.

Perhaps surprisingly, just over a fifth (22.5%) are higher rate taxpayers (compared to only 7.6% of adults\(^6\)) though, of these, the vast majority (74%) are earning less than £75,000 and are therefore at the lower end of the higher rate. Only 1.6 per cent of our respondents are additional rate taxpayers.

Thus, were rates to be increased for higher earners in Scotland, around a quarter of small business respondents would potentially be affected. That said, fewer unincorporated business owners are higher or additional rate payers (only 18%) and, as discussed, this is the group that is more likely to pay Scottish rates of tax on their income.

**Small Business and Changes to Income Tax**

We asked our members to consider their views on tax and spending in Scotland, recognising that business owners would likely hold a range of opinions about the right approach for Scotland in the current financial and economic climate.

A clear majority (58.3%) told us that income tax rates should remain unchanged. A fifth felt that rates should be decreased, while a similar number (21%) want tax rates increased. This suggests that, while the majority of political party manifestos advocated an increase in income tax rates, the majority of small businesses remain unconvinced by this approach. As one member stated:

\(^5\) p33 of the Scottish Government’s discussion paper sets out the impact of different proposals for a variety of income levels.

\(^6\) *ibid*
“The impact will depend on how much the [increase] is going to be. Potentially it will impact business growth and employment. Expansion and refurbishment plans may have to be cancelled or postponed.”

Higher rate taxpayers were more likely to feel that income tax rates should be decreased (35.2%) and less likely to say they should be increased (9.9%).

**Figure 3: Thinking about your views on tax and spending in Scotland, do you think the Scottish Government should:**

![Chart showing the distribution of responses regarding income tax rates](chart)

Similarly, thinking about the impact on business and the economy overall, the majority felt that increases to income tax would have a negative effect. Almost two thirds (65%) thought it would be detrimental to the economy, with higher rate taxpayers again more likely to feel this way (74.3%):

“**It would put an extra burden on businesses in an already struggling marketplace.**”

A number of businesses commented that such a move would deter business growth and ambition in Scotland and might push entrepreneurs to move away. This was a common theme with one member stating that:

“**If we have a different rate of tax to the rest of the UK, it could lead to individual and business relocation &/or restructuring of remuneration leading to reduced tax take for Scotland.**”

Some also referred to the impact upon wages and, particularly, the potential squeeze on disposable income of consumers being bad for business. Comments also
highlighted concerns about increasing taxes when the economic outlook is so uncertain.

**Figure 4: If income tax was increased, what impact do you think this would have on business and the economy overall?**

On the other hand, almost a fifth (18%) thought increases in income tax would be beneficial, while a similar proportion (17%) felt it would make no difference to the economy. Female business owners were slightly more likely to say that increases to income tax would be beneficial (25.5%). Some businesses commented on the business benefits of investing in public services and infrastructure, while others made the point that their support for increased tax rates was dependent upon effective spending of this revenue:

“It depends on the purpose, how it is spent, and increased by how much. I really don’t mind paying my fair share of tax even though we are not some rich business, but just a micro-business making ends meet and trying to build the local economy and the future.”

We also narrowed the question down, from looking at the economy as a whole to the impact increases in income tax would have on members’ own businesses. . This revealed that, while the most common response (cited by 24.4%) indicated that an increase in tax would have no effect on their business or financial decisions, almost two thirds picked an option denoting a negative impact:

“In our competitive line of business, I would see already tight margins being squeezed and would have to consider how viable it would be to continue trading in the long term.”

Just under a quarter (23.4%) indicated they would reduce planned investment in their business; 21.2 per cent said they would seek to reduce their taxable income; 5.4 per
cent would close their business, while 14.4 per cent indicated that they would consider moving their business out of Scotland.

**Figure 5: If income tax increased in Scotland, what impact would this have on you?**

Perhaps surprisingly, the data does not suggest that those considering moving their business out of Scotland are limited to higher rate taxpayers and a number commented that they had already explored relocating their business elsewhere in the UK.

As discussed earlier, a challenge of the new income tax landscape is the interconnected nature of different taxes and reliefs and the subsequent difficulty managing behaviour change which may flow from changes to income tax. Further, the Scottish Government has limited control over other taxes and reliefs.

It is therefore interesting that around a fifth of businesses indicated that they would seek to reduce their exposure to Scottish tax rates, perhaps by incorporating their business (and relying upon dividend income). The extent to which incorporation would be an attractive alternative would depend upon the level of income and profit, however an increase in incorporation may well be an unintended consequence of higher income tax rates in Scotland.7

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7 Such a change, albeit limited, would potentially reduce income tax paid in Scotland and increase payment of reserved taxes i.e. tax paid on dividends (at UK rates) and corporation tax.
Lastly, we asked businesses for their views about the options for change outlined by the Scottish Government. With the majority of respondents being basic rate taxpayers, we might expect that most would pick a proposal which increased rates only for higher and additional rate taxpayers.

**Figure 6: If you had to pick one of the Scottish Government approaches, which would be your preferred option?**

Instead, perhaps surprisingly, by far the most popular of the four options was ‘approach 4’.

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<th>TABLE 13: APPROACH 4</th>
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<tbody>
<tr>
<td><strong>Gross income</strong></td>
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<tr>
<td>£11,850 to £15,000</td>
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<tr>
<td>£15,001 to £24,000</td>
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<td>£24,001 to £44,290</td>
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<td>£44,291 to £75,000</td>
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<td>£75,001 to £150,000</td>
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<td>Above £150,000</td>
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This option, chosen by almost half (48.8%), and arguably the most radical, proposes six rates of tax (instead of the current three), to better reflect the wide spectrum of

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8 These options are set out in detail on p35-37 in the Scottish Government’s income tax discussion paper.
earnings. Around a third (32.7%) favoured the more modest ‘approach 1’ which suggests slight increases for higher and additional ratepayers. Approaches 2 and 3, which include different changes for mid and higher earners, were significantly less popular.
Further Information

For further information please contact Susan Love, Policy Manager at: susan.love@fsb.org.uk
The FSB is Scotland’s largest direct-membership organisation. It campaigns for a better social, political and economic environment in which to work and do business. With a strong grassroots structure and dedicated Scottish staff to deal with Scottish institutions, media and politicians, the FSB makes its members’ voices heard at the heart of the decision-making process. It is therefore recognised as one of Scotland’s most influential business organisations. The FSB also provides a suite of services to help our members reduce the cost and risk of doing good business – from legal and tax protection to business banking.