TARC
Tax Administration Research Centre

PROJECT BRIEFING

Income Shifting and Responses to Tax by Company Owner-Managers

Overview

There has been substantial growth in the numbers of people who are running their own business, as opposed to being an employee in someone else's business.

Company owner-managers are particularly responsive to changes in tax rates. For example, they are known to bunch at the higher rate income tax threshold.

In this project we explore the mechanisms that owner-managers use in order to bunch at thresholds. We show that much of the response results from shifts in taxable income across time.

Challenge

We know that there are various mechanisms that company owner-managers can use to adjust their taxable income. These include retaining profits within the company in order to smooth personal taxable income over time. However, to date we've had little more than anecdotal evidence on the extent to which people do this. The aim of this project is to take those company owner-managers who are bunching at income tax thresholds and decompose their overall response into the different mechanisms used. In particular, we are interested in how much of the response comes from reductions in business activity or from shifting income across tax years.

Analysis

We use a new link between the personal and corporate tax records of UK company owner-managers. This provides a more complete picture of the activity of owner-managers. In particular, it allows us to see how people adjust both business activity and the timing and magnitude of the personal income payments they take from their business. We use a bunching framework to analyse responsiveness to the increase in the marginal tax rate of 20 percentage points at the higher rate threshold.

Research Outcomes

We show that the annual taxable income of company owner-managers is responsive to tax. In line with the previous literature, we find an implied *elasticity of taxable income (ETI)* of 0.1. We also find that a substantial proportion of this responsiveness is due to short term shifting of dividend income across tax years. The evidence suggests that the remainder of the response is likely due to longer term income shifting and not to changes in real activity. Company owner-managers have an incentive to retain profits in the business until company sale or liquidation because, in most cases, this allows them to take advantage of favourable capital gains income tax rates.

Implications

The elasticity of taxable income has been hugely influential in the policy debate. For example, much of the discussions surrounding the 50p top rate of UK income tax focused on the fact that a high ETI implied that the policy would raise relatively little revenue. By understanding what drives the ETI, we can better understand how to design tax policy.

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