Office of
Tax Simplification

Small business tax review: Final report

Disincorporation relief

February 2012

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Foreword

Unlike other Office of Tax Simplification (OTS) projects, which have looked at significant areas of the tax system, this report is a study of a single question: should there be a disincorporation relief? It is not a new question: a disincorporation relief has been regularly mooted over at least the last quarter of a century. Discussions and formal consultations have taken place but nothing further has happened.

So what has happened to bring this issue back onto the agenda – and what is the answer to that question? In simple terms, we were told by many people during the first stage of our small business project that a disincorporation relief was needed. And, having looked carefully at the evidence over the last six months, we think there is indeed a need for such a relief. This report therefore recommends to the Chancellor that a disincorporation relief should be brought into the UK's tax system.

It may strike the reader as odd that the OTS – whose rationale is surely to trim the tax code – is recommending something that will add a few pages to the tax legislation. That reaction is pardonable but misunderstands our role. The OTS's aim is indeed to look for ways of simplifying the UK's tax system – but we look at both technical and administrative simplifications. If the tax system is getting in the way of business doing what it wants to do, or adding burdens to valid business choices, those are complexities. Developing ways to remove or circumvent the tax barrier is a simplification. That is what we have here.

Of course, a new relief has to pass some rigorous criteria – see, for example, those we used in our report on tax reliefs, which we have naturally had firmly in mind for this project! We think the proposed relief passes the criteria: it can be tightly targeted, meets a real business need, will be used (not by vast numbers, but it will be used) and can be effected quite simply (we think it needs about three pages of legislation). The tax cost is an interesting question but as this is to facilitate the smallest businesses managing what they do more easily, we think any tax cost – which we think will in any event be modest – should be seen as an investment in this vital sector.

That this report has come to fruition is thanks to a number of people, notably Andy Richens, one of the OTS's secondees, who has led the drafting. He has had key support from a number of our other secondees – Caroline Turnbull-Hall and Richard Thomas – with Anish Mehta and all the OTS team in the backing band. Our Consultative Committee has given very valuable input throughout the project and we have received many comments on the questions posed in our discussion paper from a wide variety of individuals and organisations. This is certainly a subject that has aroused a good deal of debate. Great thanks are due to all these many contributors: the OTS cannot hope to perform its tasks without such support.

John Whiting

Tax Director, Office of Tax Simplification

Executive summary

As part of the second and final stage of the small business tax review, the Government asked the Office of Tax Simplification (OTS) to explore the case for a relief for disincorporation as a means for removing tax barriers to changing the legal form of a business. The final stage of this review also covers recommendations for improving administration of the tax system for small businesses, and a simpler income tax for the smallest businesses, which are set out in separate papers alongside this document.

The OTS published a discussion paper on disincorporation relief on 28 July 2011. This final report is based on the formal responses received, together with data obtained from surveys and from HM Revenue & Customs (HMRC). This evidence has been supplemented by a series of roadshows across the country for small businesses and their tax advisers, and discussions with HMRC, HM Treasury and our Consultative Committee.

The relief targets "micro" companies which no longer wish to operate through a corporate entity and have no commercial need to do so. Sole trader or partnership is the more natural form for many small businesses but tax incentives, both past and present, have encouraged many businesses to incorporate. There are, however, many very small companies that require a corporate structure for commercial reasons.

A disincorporation relief would enable the business to be removed from the additional administrative burdens that face a limited company. This would allow the proprietor(s) to focus more of their time on running their business, while facing less scope for administrative complications such as overdrawn directors' loan accounts. Unincorporated businesses may also be able to access simplifications that result from the OTS's paper on simpler income tax for small businesses. **The OTS believes that this would have a positive impact on the performance of these businesses**, including reduction of their administrative costs.

The evidence obtained suggests that **a small but significant number of small businesses would like to disincorporate**, with 14% of companies surveyed stating they would prefer to operate as an unincorporated business. However, a double tax barrier is currently in place, acting as a disincentive to leave the corporate structure. Indeed, 20% of agents surveyed said that at least 1 in 10 of their incorporated clients "would like to disincorporate but cannot or do not because of potential tax charges that would arise at the point of disincorporation".

The OTS therefore proposes the introduction of a relief, which at a minimum will allow the business of a company, including in particular its goodwill, to pass to an unincorporated business with no tax charge arising at that point. We also see a strong case for the relief to cover property and machinery and plant used wholly in the trade of the business. Our view is that the relief should only be available to trading companies. We also recommend a time limited relief of up to five years, with a formal review at that point. Full details are set out in Chapter 5.

The tax cost of the relief will need to be assessed but our research suggests it will be minimal, particularly in the short term. It needs to be borne in mind that at present, in the absence of a relief, businesses do not disincorporate. As a result, use of the relief will not lead to a tax loss for the Exchequer at the point of disincorporation. The continuing business is potentially liable for higher income tax and national insurance contributions (NICs) as an unincorporated business, although it may face lower tax charges for gains on assets at the point of sale or cessation of the business.

Additionally, the OTS believes that **take up of the relief should be straightforward for the business**. We recommend that a joint Companies House and HMRC working group be set up to look into the introduction of a simplified one-stop disincorporation procedure. We also believe that Government should actively communicate the relief to businesses that are likely to benefit.

Overall, **this is a proposal to facilitate business reorganisations at the smallest end of the business sector**. It has the potential to allow such businesses to change the way they operate to a more efficient model, without incurring a significant tax cost.

Finally, it is important to stress that the OTS has been set up to advise Government, and cannot make policy decisions itself. We have presented these recommendations to the Chancellor of the Exchequer and anticipate a formal response as part of Budget 2012. Ultimately, it will be the Chancellor who decides on any changes, which would be subject to the normal Parliamentary process.

1 Introduction

Previous reports and discussion papers

1.1 On 10 March 2011 the Office of Tax Simplification (OTS) published an interim report on areas of complexity and uncertainty for small businesses and recommended priority areas for simplification[1]. The Government subsequently asked the OTS to undertake further work in three main areas:

- improving HMRC's tax administration for small businesses;
- a new system for taxing the smallest unincorporated businesses; and
- a possible new tax relief for disincorporation[2].

The terms of reference were for recommendations to be made to the Chancellor before Budget 2012.

1.2 This report is on a possible disincorporation relief. The strands relating to simplifying income tax for the smallest unincorporated businesses and HMRC administration are being published as separate, self-contained reports alongside this document. Where relevant, the links between the documents and the recommendations have been made clear.

1.3 On 28 July 2011, the OTS published a discussion document on disincorporation for small companies[3]. We received six formal responses to the paper, all from firms or professional bodies, and are particularly grateful to the organisations that responded. To supplement these comments and our previous work, we gathered survey evidence from The Futures Company (TFC)[4] and from a survey of tax agents for small businesses[5]. This evidence has been taken together with views obtained in a series of meetings around the country over the last six months and very helpful comments and guidance from our Consultative Committee[6]. This paper reports on all these activities and arrives at proposals for a form of relief on disincorporation.

1.4 The OTS is grateful to all respondents for their contributions and also to HMRC and HM Treasury for access to data and assistance in analysis. We should make it clear, though, that the final conclusions and proposals in this paper are those of the OTS and not necessarily those of our many contributors.

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1 http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

2 In strictness, there is no such thing as 'disincorporation': a company that transfers its assets to its shareholders and ceases to exist would normally be referred to as liquidating or dissolving. In this paper, as in the previous discussion paper, disincorporation is to be taken as the passing of a company's assets and activities to its shareholders, who continue to carry on those activities. The company, now a shell, would normally be wound up or struck off in some way.

3 Disincorporation for small companies: discussion paper. http://www.hm-treasury.gov.uk/d/ots_disincorporation_of_small_companies_discussion_paper.pdf

4 The OTS and HMRC commissioned a joint piece of research from The Futures Company that reported to the OTS in December 2011. A summary report is available via the OTS website: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

5 The OTS launched a survey of tax agents in November 2011. This was circulated via a number of tax bodies and was also available on the OTS website. The survey received over 700 responses.

6 A full list of Consultative Committee members and minutes from meetings are available on the OTS website: http://www.hm-treasury.gov.uk/ots_smallbusinessreview_committee.htm

Policy intention

1.5 There are additional administrative burdens, and therefore associated professional and other costs, involved in operating through a limited company. By removing the tax barriers that currently stop disincorporation, some businesses could elect to be removed from these burdens, leaving more time available for running their business, and reducing administrative costs and complexities.

1.6 Any new relief would need to satisfy the criteria set out in the OTS Review of Tax Reliefs[7], including evaluation of the rationale for a relief, likely take up of the relief and, in particular, the level of complexity in claiming the relief. There is also the question of the cost of the relief to the Exchequer. These criteria are reviewed in Chapter 4.The OTS is very mindful of the view that a new relief, however simple, will add more complexity to the tax system.

[7] Review of Tax Reliefs: Interim report, December 2010: http://www.hm-treasury.gov.uk/d/ots_review_tax_reliefs_interim_report.pdf

2 Current tax barriers to disincorporation

2.1 Disincorporation, for the purposes of this paper, means a transfer of a business from a company to its shareholders, who then continue to carry on the business in an unincorporated form ("the successor business"), whether as a sole trader or a partnership. It does not strictly need to involve the striking off or liquidation of the company, which may be left dormant or used for other purposes. However, in the context of a disincorporation relief, we anticipate that in most cases the company would be wound up, or informally struck off the Companies House Register, given that one of the main drivers for the relief is for the proprietor to escape the administrative burdens of running the company[8].

2.2 The taxation system currently allows for capital gains to be held over on incorporation of a business[9], but no corresponding reliefs apply to a disincorporation.

2.3 The main tax consequence under current tax law of a disincorporation is a potential double tax charge on gains from the assets transferred: first on the company (which disposes of its assets) and second on the shareholders (who dispose of their shares). This double charge is inherent in the nature of the corporate status but is a barrier to many of the smallest businesses that wish to continue their business in a more suitable legal form.

Gains charged to the company:

2.4 All businesses will have an element of goodwill[10]. On a transfer to a successor business, the goodwill must be valued[11], as the asset is deemed to have been disposed of at its market value[12]. Agreeing the value of the goodwill with HMRC can be a lengthy process and this can be burdensome for all sides.

2.5 For a business which commenced after 31 March 2002, or was acquired after that date from an unrelated party, goodwill is dealt with for tax purposes under the intangible fixed asset rules[13], and any gain would be taxable as trading income on the company[14]. Where the business was carried on before 1 April 2002, a chargeable gain may arise on the transfer of goodwill.

2.6 In all cases, chargeable gains may also arise on the transfer of other assets, including land and property, to the owners of the successor business. As with goodwill, the value of the chargeable assets must be ascertained and are deemed disposed of at their market value.

Gains on the shareholder(s):

2.7 In the course of winding up a company, a distribution of assets to the shareholders is a capital distribution chargeable to capital gains tax on the shareholder[15]. However, a distribution,

[8] It would be possible to design the relief so that the company was always wound up and that might answer some concerns voiced to the OTS about avoidance possibilities.

[9] s162 TCGA 1992; S165 TCGA 1992 (Gifts of Business Assets) can also be used in some situations.

[10] For HMRC guidance on goodwill, see: http://www.hmrc.gov.uk/manuals/cgmanual/cg68010.htm

[11] s845 CTA 2009

[12] s17 TCGA 1992

[13] Part 8 CTA 2009

[14] The transfer of intangible assets other than goodwill will also give rise to a tax charge, and again would need to be valued.

[15] s1030 CTA 2010, s122(5) TCGA 1992.

otherwise than in a winding-up, is an income distribution by virtue of s1020 CTA 2010 and chargeable to income tax.

2.8 On a disincorporation the shareholders will be charged to income tax or capital gains tax, based on the excess of the amount of the distribution received over the tax cost of their respective shareholdings. Box 2.A sets out the legislative changes recently enacted in this area.

Box 2.A: Enactment of Extra Statutory Concession (ESC) C16[16]

ESC C16 applied to distributions in anticipation of striking off from the company register. It applies until 29 February 2012; the concession has now been legislated. It has a significant impact in the area of disincorporation.

A company which has ceased business and does not wish to undertake the administration and incur the costs of going through a formal winding up procedure may simply distribute its assets to its shareholders, and seek to be struck off the Joint Stock Companies Register and be dissolved[17].

In the absence of formal winding up proceedings, such a distribution would be an income distribution, liable to income tax. However, the terms of ESC C16 allowed such a distribution to be treated as a capital distribution in the hands of the shareholders, subject to various assurances from the company, including that the company did not intend to trade in the future, applied for striking off, collected debts and paid off creditors.

The House of Lords decision in *R v Commissioners of Inland Revenue, ex parte Wilkinson*[18] clarified the scope of HMRC's administrative powers, and legislating ESC C16 is part of a programme to give statutory effect to those concessions which may exceed the scope of that discretion.

A consultation document[19] was published by HMRC on 13 December 2010, which proposed the introduction, for anti-avoidance reasons, of a ceiling of total distributions in anticipation of dissolution of £4,000. The legislation has now been enacted, and the ceiling for total distributions (in anticipation of dissolution) to access capital treatment has now been set at £25,000. This will apply to distributions made on or after 1 March 2012.

There is a measure of overlap between what was ESC C16 and the proposed disincorporation relief. But the two processes do serve different objectives: the ESC normally applied on the cessation of the business; the OTS relief assumes that the business can be carried on better in another form. Companies where the trade is carried on by the shareholders following dissolution will be assisted by a disincorporation relief, which will exempt qualifying assets (see Chapter 5) from the distribution charge otherwise arising.

[16] Enactment of Extra-Statutory Concessions Order 2012 SI 2012/266 Article 16.

[17] ss1000 or 1003 Companies Act 2006.

[18] *R V HM Commissioners of Inland Revenue ex parte Wilkinson [2005] UKHL 30.*

[19] Extra Statutory Concessions: Fourth technical consultation on draft legislation http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_030872

2.9 In addition to the treatment of chargeable gains and income gains under Part 8 CTA 2009, other tax issues may arise on a transfer of a business from a company:

- the stock and work in progress would be deemed to be disposed of at its market value. However, the parties may elect[20] for the actual transfer value to be used (or the book value if higher) so that no charge is raised on transfer;
- a balancing charge may arise on the disposal of the machinery and plant, based on the excess of the market value of the assets transferred over the written down value of the assets (or pool of assets). An election[21] may be made for the transfer to be deemed to be made at written down value, so that no charge is raised;
- trading losses in the company for the final year before disincorporation may be carried back and set against total profits of the final three years[22], but may not be transferred into the unincorporated business;
- capital losses, excess management expenses and non-trading loan relationship deficits of the company may not be transferred across into the unincorporated business nor, except in the case of loan relationship deficits, carried back;
- the transfer of land will give rise to a potential stamp duty land tax charge, although a transfer of the property in specie during the course of winding up the company will not give rise to the charge provided that there are no loans charged on the property; and
- where the company is VAT registered, the transfer of the business to existing shareholders would normally satisfy the "transfer as a going concern" criteria, with the result that no VAT is chargeable on the assets transferred[23]. It should also be possible to elect for the VAT registration to pass to the successor business.

[20] s167(1)-(4) CTA 2009
[21] ss265-267 CAA 2001
[22] s39 CTA 2010
[23] Regulation 5 SI 1995/1268

3 Companies that may benefit from a disincorporation relief

3.1 In its July 2011 discussion paper, the OTS set out a number of examples of companies that may benefit from the introduction of a disincorporation relief. Respondents to that paper (for full summary, see Annex B) indentified two distinct types of businesses that may benefit:

3.1.1 A small business operating through a company, with little understanding of the notion of a legal entity separate from the shareholders/directors, and the consequent failure to keep personal cash separate from the business. As a result, there may be repeated overdrawn loan account tax charges and issues. Many of these businesses may have incorporated to take advantage of the 0% corporation tax rate[24]. The additional administrative requirements add little value for these businesses.

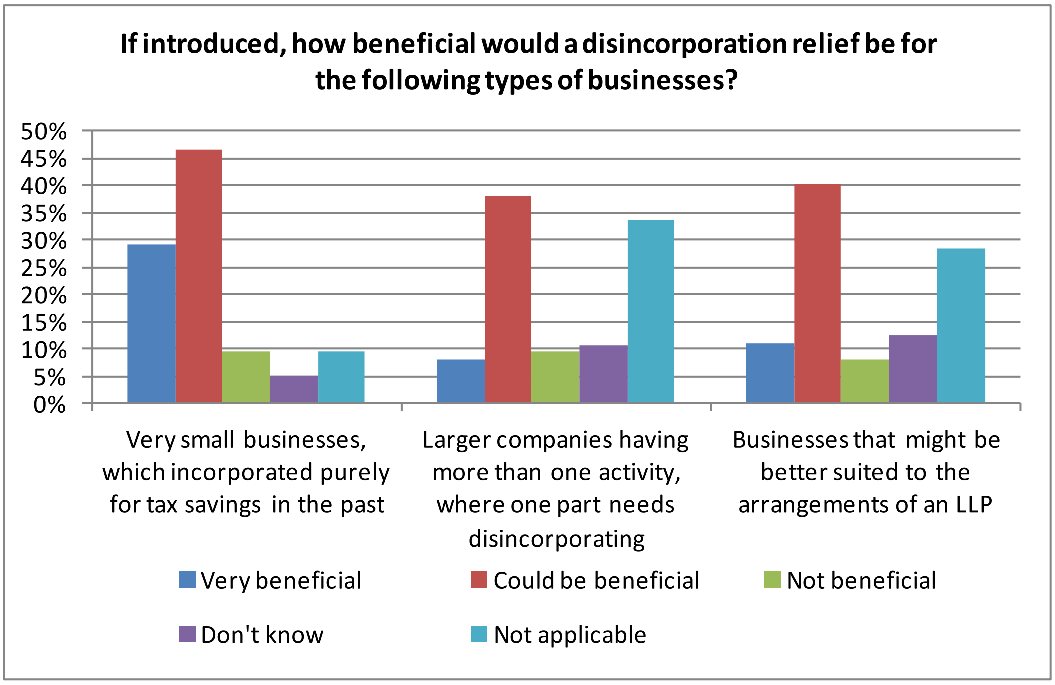
3.1.2 Older companies which have outgrown their original structure for a number of reasons, including:

- different activities being carried on within the company, with one of these better suited to being carried on as an unincorporated business. At present, a demerger followed by winding up of one of the demerged companies is necessary; and
- the shareholdings no longer reflecting the respective time invested by individual shareholders and dividend waivers being used to redress the balance, giving rise to income tax issues. With a limited liability partnership (LLP), which is taxed as an unincorporated entity, profit sharing arrangements could easily be changed.

3.2 The above scenarios were tested further in the OTS survey of agents, where 29% of agents considered that very small businesses that incorporated in the past for tax reasons were likely to find the introduction of a disincorporation relief 'very beneficial'. However, companies under 3.1.2 above scored less highly, with only 8% of agents considering that a disincorporation would be 'very beneficial' to companies wanting to disincorporate part of the business, and 11% for those that wish to move to an LLP structure.

[24] FA 2002 s32

Chart 3.A:



Source: OTS survey of tax agents, December 2011

3.3 In terms of administrative difficulties for companies, the agents' survey also showed that a significant proportion of small companies face charges due to overdrawn loan accounts, when directors do not distinguish between personal and business spending[25]. Confusion of personal and business spending can also be problematic for unincorporated businesses, but the consequences are likely to be less severe. Approximately 25% of all agents surveyed felt that clients also have problems understanding that they are an employee of their company.

3.4 The Futures Company (TFC) research, referred to in paragraph 1.3 focused on unincorporated businesses but included 195 incorporated businesses (18% of the total sample). These companies[26] responded to the question "Would you prefer to operate as an unincorporated business (for example as a sole trader or partnership) rather than as a company?" as follows:

- 14% would like to disincorporate;
- 19% did not know whether they would like to disincorporate or not; and
- the remainder (67%) would not like to disincorporate.

Businesses with turnover between £20,000 and £30,000 per annum were more positive than average to the idea of disincorporation, as were businesses that have low confidence over their tax affairs. These are the types of business referred to in paragraph 3.1.1 above. Demand for disincorporation was higher than average for those in 'personal and domestic services' (e.g. hairdressers, gardeners) and 'childcare/health and social care'.

3.5 The OTS survey of tax agents asked agents whether their clients would like to disincorporate. As might be expected, given the tax saving that is available for limited companies relative to

[25] Of those respondents that indicated that most businesses suffer such charges, 8% said that at least 50% of their clients would like to disincorporate (compared to 4% for the population as a whole).

[26] The 195 businesses answering this question represented a broad mix of companies by age, region, sector and number of employees. All of the businesses had turnover below £1million, and approximately 50% were below the VAT registration threshold.

unincorporated businesses[27], 38% said none of their clients would like to disincorporate. However, a significant proportion (20%) of respondents said that at least 1 in 10 of their incorporated clients "would like to disincorporate but cannot or do not because of potential tax charges that would arise at the point of disincorporation".

3.6 As part of the research, we asked about the costs of advice for ongoing small businesses. Unsurprisingly, the vast majority of the OTS agent survey sample charge more in fees to limited companies than to equivalent unincorporated businesses. The most common response (26%) was that fees are between 25% and 50% higher for limited companies, while 36% of the sample said that fees are at least 50% higher[28].

3.7 **The OTS concludes that the target companies for a disincorporation relief are the smaller companies identified under paragraph 3.1.1 above.**

3.8 For simplicity, eligibility for the relief would ideally link to an existing definition of business size. The OTS proposes that the EU micro business definition is used[29]. However, this definition includes businesses that are significantly larger than the main target for this relief, and it may be appropriate to restrict eligibility further[30].

[27] See paragraphs 2.15-2.19 in "Disincorporation for small companies: discussion paper" http://www.hm-treasury.gov.uk/d/ots_disincorporation_of_small_companies_discussion_paper.pdf

[28] TFC survey data also shows that sole traders (and partnerships) on average spend significantly less on dealing with their tax affairs than limited companies: 13% of sole traders spent more than £500 per year, compared to almost 75% of limited companies. However, in this data, it is not possible to separate this difference in cost from the underlying complexity of the tax affairs of the business.

[29] EU definition of a micro business: number of employees <10; and either turnover $\leq$ €2million or balance sheet total $\leq$ €2million.

[30] See also the discussion on the need for new terminology around what is a 'small' business in *Small business tax review: simpler income tax for the smallest businesses*, available at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

4 Rationale and possible forms of a relief

4.1 The OTS recognises that any new relief must satisfy the criteria set out in the interim report of our review of tax reliefs. They are as follows:

Policy rationale

4.1.1 The rationale behind the relief is to allow those small businesses that no longer wish to operate through a corporate entity to move on a tax-neutral basis to unincorporated status while continuing the business. This would free the business from the additional administrative burdens that apply to limited companies and so generate more time to spend on running the business. We do not believe that a tax charge should arise on disincorporation, particularly as relief is given at the point of incorporation.

Likely take up of relief

4.1.2 The OTS believes that the relief will be of particular value to businesses that incorporated because of the 0% corporation tax rate introduced in 2002. The companies that may consider a disincorporation relief are those where the current annual tax and national insurance savings from operating in a corporate structure are outweighed by the additional administrative costs. Initial research indicates that, looking at profits in 2009-10, this applies to approximately 15% of companies that incorporated in the 2002-03 tax year[1].

Tax cost of the relief

4.1.3 The OTS has not been able to establish the impact on the Exchequer of this relief. However, based on the design of relief set out in the next chapter, the costing should account for the tax implications of the following factors:

- At the point of disincorporation – the recommendation is that there should be relief from the immediate tax charge at the point of disincorporation. This would apply both to the company (which is disposing of its assets, insofar as they are covered by the relief) and to the shareholders (who are disposing of their shares). Currently, in the absence of this relief, companies are not choosing to disincorporate. There is therefore no immediate loss of tax revenue at the point of disincorporation. In any event, the potential loss of tax on chargeable gains on the company's assets is a deferral, not a permanent loss.

- On the ongoing profits of the business – the unincorporated business is likely to face a higher tax (and national insurance) charge on profits than a company with the same taxable profit; and

- At the point of eventual sale or cessation of the business – the unincorporated business is likely to face a lower tax charge on gains on assets. The example in Annex D sets out a comparison of this final charge.

[1] OTS analysis of HMRC data.

Administrative burden for the taxpayer, advisers and HMRC

4.1.4 At the point of disincorporation, the OTS envisages a simple procedure for the taxpayer, using the one-stop approach set out in paragraph 5.13. There will be no need to value the goodwill, property or machinery and plant passing to the unincorporated business. The capital gain held over in the company will pass to the shareholder when either the business is sold, or their interest in it reduces, and it will therefore be necessary to keep track of the original cost values. This would have been necessary without disincorporation.

4.1.5 For HMRC, limiting the relief to goodwill, premises and machinery and plant used exclusively for the trade removes potential tax avoidance by way of accumulation of cash, since this will remain chargeable as a distribution.

4.1.6 The OTS has also considered whether a company may choose to disincorporate in anticipation of the cessation of its business, to make use of lower personal rates of capital gains tax. However, to qualify for the 10% CGT rate under Entrepreneurs' Relief, the unincorporated business must continue to operate for at least one year, which would mean the business being exposed to the higher unincorporated tax regime, which would be a disincentive against any such mischief.

4.1.7 We accept that HMRC may wish to add an anti-avoidance provision in terms of a rule preventing reincorporation within a period. It may also need to consider a clawback of any disincorporation relief if the business is sold in a way that qualifies for Entrepreneurs' Relief within, say, two years.

4.2 The OTS's discussion paper on disincorporation in July 2011 put forward two possible relief options for consideration:

Narrow form of relief

4.2.1 Many small companies, comprising for example those under paragraph 3.1.1, will have internally generated goodwill. The narrow relief option would enable the goodwill to pass at a value producing no tax charge on the company, and additionally would relieve this element of the distribution charge on the shareholders. Importantly, this option would remove the need to agree the goodwill valuation at this point, a key simplification. The gain would finally arise when the successor business was disposed of.

Wider form of relief

4.2.2 The July discussion paper identified that companies, for example those mentioned in paragraph 3.1.2, may hold other chargeable assets, potentially giving rise to the double tax charge outlined in paragraph 2.3 above. The wider relief would allow for both a transfer of these assets at a value producing no gain on the company, and a deferral of at least part of the tax charge on the shareholders. Any gain would crystallise when the assets were finally sold to a third party. In many ways this would parallel the incorporation relief.

4.3 Paragraph 2.9 sets out the other tax issues, outside the narrow and wider relief options above, that may prevent companies from disincorporating. Other areas to consider are whether to restrict a disincorporation relief to trading companies only and also whether any relief should be time-limited. These are considered in the following chapter.

5 Conclusions and OTS recommendations

5.1 A summary of the responses to the OTS discussion paper is set out in Annex B. All respondents favoured the introduction of at least the narrow form of relief. While many felt that a wider form of relief would be used, it was recognised that this would probably require extensive anti-avoidance measures.

5.2 The OTS has aimed to strike the right balance between assisting the disincorporation process and an efficient return on legislative time. A schematic of the form that legislation might take is included at Annex C, to give an idea of the likely length of legislation needed. The OTS thinks that it would need approximately three pages.

5.3 In summary, **the proposed relief would enable a company holding internally generated goodwill, plus land and buildings and machinery and plant used wholly for the trade, to pass to an unincorporated structure, with no tax charge arising on the company, and no distribution charge on the shareholders, as a result of the transfer of those assets**. Any gain arising on the value of goodwill, and on the land and buildings used for the trade would be charged when the business (or the individual asset) is disposed of. For example, a business that started life as a sole trader, then incorporated, and subsequently disincorporated back to sole trader, would continue to hold the goodwill and land and buildings used for the trade for tax purposes as if the transfer into a limited company had never occurred.

5.4 **The OTS does not propose extending the relief to include the areas raised in paragraph 2.9 or to include transfers of trades to LLPs**. Elections already exist to ensure tax free transfer in respect of stock and work in progress, balancing charges on machinery and plant and VAT under the transfer as a going concern provisions. Operating as an LLP does not provide the same level of administrative savings as operating through a partnership or sole trade.

5.5 There is then the question of **loss reliefs**. There is a case for losses – certainly trade losses – to be carried over to the new trading business in some way. However, that would require complex rules and we do not think that is justified in what is intended as a simple relief. In any event, we think that the single-person companies targeted for the relief are not likely to be loss-making. Accordingly, **we do not recommend extending the relief to losses**. Any trading losses would be eligible for three-year carry back within the company on cessation; other losses would not be eligible for relief.

5.6 **The target for the relief is very small companies that do not require the corporate structure for commercial reasons.** Many of these will be businesses that incorporated in the past for tax reasons. However, it should be remembered that rates of tax are only one consideration in deciding whether to run the business through a corporate or unincorporated form. For example, many agency and contractor workers are obliged to operate through limited companies for reasons outside the scope of this paper.

5.7 We have had representations that the relief should be extended to property investment businesses. We think this would open avoidance concerns, and therefore **the proposed relief would only apply to a trading company**.

5.8 One suggestion has been that the introduction of a disincorporation relief would lead to businesses regularly changing between incorporated and unincorporated structures, to access a lower effective rate of tax. The OTS does not see this as a reason to restrict relief. It would be possible to insert a simple provision to prevent regular switching of status.

5.9 A further suggestion has been that a business may re-incorporate and operate in a 'phoenix' form, having accessed previously undistributed profits. The narrow relief option ensures that only the goodwill, property and machinery and plant used wholly for trade would be excluded from the distribution charge, so any other undistributed reserves would still be taxed, meaning the practice would not achieve any advantage. Further, the transactions in securities legislation[32] would apply to transfers that are not ordinary disincorporations[33].

5.10 One point to note is that at present there is a considerable incentive in the tax system towards incorporation. The OTS interim report[34] on small business published on 10 March 2011 made the radical recommendation of integrating income tax and national insurance. A full integration, not limited to merging the administrative operations, would reduce the tax differentials between the various trading vehicles meaning the choice of business medium would not be driven by tax considerations. For the moment, the Government is proceeding with studies working towards combining the operation of the two levies[35].

5.11 The July discussion document considered whether a time-limited disincorporation relief would be appropriate. We naturally see merit in reviewing tax legislation for its effectiveness and use. Thus **we would recommend a time-limited relief of up to five years, with a formal review as to whether to make the relief permanent at that time.**

5.12 The OTS report into small business administration, published alongside this report, recommends advertising the various HMRC initiatives available to assist small business. In keeping with this, **we recommend that HMRC actively communicates the availability of the relief to the target population that is most likely to benefit.**

5.13 At present, if a company were to transfer its business to an unincorporated structure, the owners would need to deal with both HMRC and Companies House. The **OTS recommends that a joint working group is set up by these two organisations with a view to the introduction of an optional one-stop process to carry out the disincorporation and dissolution of the company**, which will also help address any concerns from HMRC regarding avoidance issues.

[32] ITA 2007 Part 13 Ch. 1

[33] It is considered that the decision in Joiner v CIR (1975] STC 657 concerning 'ordinary' liquidations should also apply to ordinary disincorporations.

[34] Small Business Tax Review: Interim Report, March 2011 available at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

[35] See http://www.hm-treasury.gov.uk/tax_income_nics.htm

A A relief for disincorporation: terms of reference

A.1 The OTS interim report on Small Business Taxation suggested there was a case for a form of "disincorporation" relief. This follows feedback that businesses that wish to stop operating through a limited company can encounter tax, legal and administrative barriers that prevent them from doing so. Reflecting this, the Government has commissioned the Office of Tax Simplification to:

- review the need for a form of tax relief for businesses which no longer wish to operate as incorporated entities;
- explore possible forms for this relief, whether operating at company or shareholder level (or both), together with any interaction with other legislation, especially the Companies Act 2006, as well as the need for protection of creditors, minority interests and the Exchequer.
- quantify the number of businesses that would adopt or be eligible for such a relief and the potential cost to the Exchequer; and
- fully develop any recommendations for a disincorporation relief, if a case is identified for it.

A.2 The review should have regard to:

- the wider economic and policy implications of any proposals – including impact on businesses and their shareholders, fairness between different taxpayers, wider Government policy and tax receipts;
- protection of minority interests and shareholders;
- the legislative implications of introducing such a relief, including risks of additional complexity and any necessary anti-avoidance measures;
- interaction with Companies Act 2006, and other legislation – and the concept of a single person new entity currently under consideration by BIS; and
- the Spending Review resource constraints on HMRC.

B Summary of responses to OTS discussion paper on disincorporation

B.1 The OTS discussion paper on disincorporation was published on 28 July 2011. Formal responses were received from:

- Association of Chartered Certified Accountants (ACCA);
- London Society of Chartered Accountants (LCSA);
- Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW);
- The Institute of Chartered Accountants of Scotland (ICAS);
- Deloitte; and
- The Professional Contractors Group (PCG).

B.2 The Chartered Institute of Taxation and Association of Taxation Technicians invited us to meetings of their relevant committees to discuss the OTS discussion papers and in view of the discussions did not submit a formal response.

B.3 A summary of the responses received is set out below the questions asked in each chapter of the discussion paper.

Chapter 2 – Why introduce a disincorporation relief?

- What are the drivers for a company to disincorporate its business? Is it simply a question of administrative savings?
- Are there further significant factors that influence the incorporation decision (other than those listed in paragraph 2.13 of the paper) that need to be considered in the context of a disincorporation relief?
- What evidence is there that businesses would wish to disincorporate? Are there particular categories of business that would wish to take the route?

The drivers identified by respondents were administration savings, privacy, national insurance savings for employees (making them partners instead) and symmetry of the tax system. Disincorporation would also enable businesses to access proposals made on a simple income tax.

Chapter 3 – Current tax implications of disincorporation

- Should any disincorporation go hand-in-hand with the company being wound up? Is there any reason to leave the winding up to a separate decision and procedure or would it be sensible to tie the stages together into a single composite procedure?
- Are there any significant further tax or general issues on disincorporation other than those listed in Chapter 3 that need to be considered?

A majority did not see the need to link a disincorporation relief with winding up the company, citing the example of only disincorporating a distinct part of the company.

Others did note the benefit of a single composite procedure to disincorporate and wind up the company but suggested it need not be compulsory to do so.

Other issues raised for consideration were the differing tax treatment of loan relationships, and the treatment of company pension schemes.

Chapter 4 – Which companies may benefit from a disincorporation relief?

- Do the five examples in paragraph 4.2 of the paper correctly identify situations where a disincorporation relief may be commercially desirable? Are there any further examples?
- Should investment companies, including property investment companies, be excluded from any disincorporation relief?
- What would be the best way to define the size and type of companies that should benefit from a possible disincorporation relief?

The majority of respondents thought investment companies should be included (in the interests of symmetry with s162 TCGA1992 incorporation relief), and if a restriction was necessary for size, it should use an existing definition with the Companies Act 2006 definition being preferred.

Chapter 5 – What might a disincorporation relief look like?

- What are people's views on the suggestions we have put forward for a narrow and wide form of disincorporation relief? Are there any other suggestions for a relatively simple form of relief?
- Does the "narrow form" of relief successfully address the main tax barrier to disincorporation? Are there any simpler ways in which a narrow form of relief could be designed to tackle the capital gains tax barriers to disincorporation?
- Is there evidence that any of the further tax issues listed, outside the narrow and wider options for relief, are preventing companies from disincorporating?
- Would the "wider" relief be open to abuse? If so, how? Would a bona fide commercial test be sufficient to protect the Exchequer? Would the protection need to go further, such as the chargeable payments rules in the demerger relief?

All respondents thought the narrow relief (holding over goodwill charges and deferring the need to value goodwill) would be a positive step and a good starting point. Some additionally wanted to go for the wider reliefs but could see that this would need greater policing and anti-avoidance provisions.

It was hoped that the chargeable payments rules would not be introduced into this relief, as it was thought that a 'stand in shoes' approach to the relief was unlikely to lead to avoidance.

Evidence from meetings held suggested the employment related securities issues on introducing new shareholding directors is contrary to the Government's growth agenda. Relief would enable additional members to join the unincorporated partnership in the future, avoiding these problems.

Chapter 6: Would a disincorporation relief be a simplification?

- Do you have any comments on the balance of simplification (of business structures) against the added complexity of further legislation?
- Could a disincorporation relief be written simply – perhaps just the "narrow" option presented?

All respondents supported introducing a disincorporation relief.

One respondent suggested starting with the narrow relief and reviewing to take further after one year.

It was generally accepted that the wider relief would not represent as good a return on legislative time. In particular, relief for the shareholder would require a review of the treatment of retained profits.

C Schematic of legislation

C.1 The OTS envisages that legislation to give effect to the proposals for a relief on disincorporation would need to cover the following points.

Chargeable gains: company to shareholders transfer

C.2 A provision would be needed (to be inserted into the Taxation of Chargeable Gains Act 1992 (TCGA 1992)) to give effect to the proposal that a disposal of certain assets on a disincorporation should not give rise to an immediate tax charge (or loss). This would involve providing that the consideration for the disposal by the company should be such as gives rise to neither a gain nor a loss, and that the transferees use the amount of that consideration as their base cost for the purposes of TCGA 1992, so that any gain (or loss) that would otherwise have arisen in the company is effectively transferred to the shareholders and recognised when they dispose of the assets.

C.3 The same provision would need to set out the case and the conditions for the disincorporation relief to be available. At a minimum it would need to provide that:

- there must be a disposal of a trade, that is of all the assets of the trade (though any cash of the trade need not be included). If, unusually, the company carries on more than one trade, it need only dispose of the assets of one trade;
- the disposal must be by a "trading company". This means a company whose main activities are the carrying on of a trade (derived in s165A TCGA 1992). Undertaking other activities, if less substantial than the trade, would not prevent there being a disincorporation;
- the trading company must be a micro business, that is a micro enterprise as defined in the Annex to the European Commission Recommendation 2003/361/EC of 6th May 2003, concerning the definition of micro, small and medium-sized enterprises. This is to ensure the relief is targeted to achieve the greatest simplification at minimal cost in tax revenues;
- the transfer must be to the company's shareholders;
- the transfer must be by way of a distribution, whether in a formal winding up or otherwise, and may be made in the circumstances set out in s1030A Corporation Tax Act 2010 (CTA 2010) (the section being inserted in that Act by Article 16 SI 2012/266, giving legislative effect to ESC C16 (company ceasing to exist without winding-up));
- the shareholders receiving the distribution must not include a company; and
- the shareholders must continue to carry on the trade of the company and must do so in partnership if there is more than one of them.

C.4 The assets distributed by the company to which the tax neutral treatment is to apply are to be limited to:

- goodwill of the company;
- land which must include buildings that have been used by the company solely for the purposes of its trade (e.g. office, factory, warehouse) throughout their ownership by the company; and
- machinery and plant (apart from fixtures which are included in land) that have been used by the company solely for the purposes of its trade throughout the period of ownership by the company.

These are referred to below as "qualifying disincorporation assets".

C.5 There may need to be a provision that gives a rule for allocation of the total base cost between partners. Each partner would be treated as acquiring a share of the base cost and we suggest that the share could be the same as the partner's percentage share of partnership capital profits in the first period of carrying on the acquired trade.

C.6 In order to ensure that any gain that would have arisen in the company but for the deferral of gain or loss described above, is brought into account at some point, legislation would need to provide that certain events which do not normally count as disposals are treated as such.

C.7 One such event is the emigration of a former shareholder, but only if the asset moves out of the UK tax net. So if the shareholder continued to carry on the trade through a UK branch permanent establishment (which might be a partnership) emigration would not trigger a disposal.

C.8 Consideration would need to be given to the event where a partner ceases to be a partner or reduces his or her percentage capital profit share, if a gain does not arise as a result of the application of ss59 or 59A TCGA 1992 taken with Statement of Practice D12.

C.9 In one or both of these cases we envisage that a disposal be treated as occurring and that the consideration for the disposal will be the then market value of the asset concerned.

Capital gains tax: distributions

C.10 Provision will be needed in TCGA 1992 to cover aspects of the tax treatment of a distribution made in a disincorporation. We envisage that the distribution will be a capital distribution:

- where it is made in a winding up (as now); or
- where it falls within s1030A of CTA 2010[36], and this rule will apply even if the £25,000 limit is exceeded. But it will not apply if the value of the assets transferred apart from any qualifying disincorporation assets exceeds that amount.

C.11 Provision in TCGA 1992 would be needed so that a disincorporation distribution which is a capital distribution does not give rise to a tax charge (by virtue of s122 TCGA 1992) on the shareholders but only so far as the disincorporation involves the disposal of qualifying disincorporation assets. If it involves any other assets, the amount of the distribution will be the market value of those assets for the purposes of TCGA 1992. This proposal would remove the need to value goodwill, which is a complex matter, and land.

[36] Replacement of ESC C16

C.12 There may need to be legislation to cater for cases where s162 TCGA 1992 applied when the company was incorporated.

Intangible fixed assets

C.13 Provision will also be required to amend Part 8 of the Corporation Tax Act 2009 (CTA 2009) which deals with intangible fixed assets, as goodwill is one of the assets for which we intend to give relief.

C.14 We envisage that a section of Part 8 would provide that if the same conditions as apply to the TCGA 1992 rule for the company apply to a company for which goodwill is an intangible fixed asset within Part 8, the goodwill would be treated as realised on the transfer for its tax written-down value for the purposes of that Part. But there may be a need for a different rule in some cases to prevent exploitation of differences between the company tax treatment and that of individuals.

C.15 A consequence of the rule for Part 8 CTA 2009 set out above is that the individual acquiring goodwill to which Part 8 applied would be treated for the purposes of TCGA 1992 as acquiring it for the tax written-down value for Part 8 purposes and not the consideration given in the TCGA 1992 tax neutrality rule.

Income distributions

C.16 Finally we suggest that in the case of a disincorporation distribution being an income distribution, a provision amending Part 23 of CTA 2010 would need to provide that the value of the distribution would be the market value of all the assets apart from qualifying disincorporation assets. This would, as with the TCGA rule suggested above, remove the need to value goodwill, which is a complex matter, and land.

D Worked example of the tax implications

D.1 The following example is included to illustrate the workings of the possible disincorporation relief. We have made this example a relatively significant company, with some fixed assets, to show the potential range of the relief. However, we suspect that many potential users of the relief would have no capital assets apart from goodwill (of arguable value) and so the relief would operate much more simply than in this example.

D.2 Lamps Ltd is a business of servicing and maintaining lights and chandeliers. Profits have been stable at around £25,000 per annum. It has one shareholder.

D.3 The table below summarises the financial position of the business. No attempt has been made to value goodwill accurately but the likely values are below. S162 TCGA 1992 relief was disclaimed.

	Value at incorporation (£)	Current value (£)
Cash	£5,000	£15,000
Debtors	£4,000	£9,000
Machinery and plant	£10,000	£15,000
Trade premises	£100,000	£150,000
Goodwill	£50,000	£80,000

D.4 Lamps Ltd is essentially a one man company with the proprietor, Derek, having difficulty understanding that his company is a separate legal entity. Consequently, there are tax issues relating to the overdrawn director's loan account and additional annual accountancy fees outweighing any tax savings that had been suggested to him when he incorporated. He would now like to disincorporate.

Example 1: The business was originally started before 1 April 2002 and incorporated 12 years ago.

The position without disincorporation relief

Tax charge on company:	£	
Gain on premises	50,000	
Gain on goodwill	30,000	
Less: indexation allowance (0.437 x £150,000)	(65,550)	
	14,450	at 20% = £2,890
Tax charge on shareholder, if there is a formal winding up and therefore a capital distribution	**£**	
Distribution (£15k+£9k+£15k+£150k+£80k-£3k tax)	266,000	
Less: initial cost (£5k+£4k+£10k+£100k+£50k)	(169,000)	
	97,000	
Less: annual exemption	(10,600)	
CGT (assuming Entrepreneurs' Relief conditions satisfied)	86,400	at 10% = £8,640
Total tax	**£11,530**	(plus liquidator's fees, say £7,500)

D.5 If the company was informally struck off, capital treatment would not be available to the shareholder because total assets exceed the new legislative limit of £25,000 and an income tax charge would apply. As the tax charge would be significantly higher than under the formal route above, it would not be advisable.

The position with disincorporation relief

Tax charge on company:	£	
Gain on premises	no gain/no loss	
Gain on goodwill	no gain/no loss	
Tax charge on shareholder, if there is a formal winding up and therefore a capital distribution	**£**	
Distribution (£15k+£9k-capital treatment as < £25k)	24,000	
Less: annual exemption	(10,600)	
CGT (assuming Entrepreneurs' Relief conditions satisfied)	13,400	at 10% = £1,340
Total tax	**£1,340**	
Tax saving at the point of disincorporation	**£10,190**	

D.6 The introduction of a disincorporation relief would create a tax saving at the point of disincorporation of £10,190. Further, there is no longer a need to wind up the company formally, saving liquidator's fees.

D.7 The business is now in an unincorporated form, and will incur additional annual tax charges. On profits of £25,000 per annum, he may pay up to £1,500 extra per annum in income tax and NICs following disincorporation[37].

[37] OTS estimate.

D.8 There will be a tax charge at the point of sale or cessation of the business. For example, after a further 5 years the business is sold, with equivalent values to those at the point of disincorporation. The capital gain on Derek is as follows:

	£	
Premises (£150,000 – £100,000)	50,000	
Goodwill (£80,000 – £50,000)	30,000	
	80,000	
Less annual exemption, say	(12,000)	
CGT (assuming Entrepreneurs' Relief conditions satisfied)	68,000	at 10% = £6,800

Example 2: The business was originally started after 31 March 2002 and was incorporated 9 years ago

D.9 Assume goodwill is written down at 4% per annum. All other values are as above.

D.10 Written down value of goodwill: £50,000 less £18,000 = £32,000

The position without disincorporation relief

Tax charge on company:	**£**	
Chargeable gain on premises	50,000	
Less: indexation allowance (0.335 x £100,000)	(33,500)	
Income gain on goodwill	80,000	
Less: written down value	(32,000)	
	64,500	at 20% = £12,900
Tax charge on shareholder, if there is a formal winding up and therefore a capital distribution	**£**	
Distribution (£15k+£9k+£15k+£150k+£80k-£13k)	256,000	
Less: initial cost (£5k+£4k+£10k+£100k+£50k)	(169,000)	
	87,000	
Less: annual exemption	(10,600)	
CGT (assuming Entrepreneurs' Relief conditions satisfied)	76,400	at 10% = £7,640
Total tax	**£20,540**	(plus liquidator's fees, say £7,500)

The position with disincorporation relief

Tax charge on company:	**£**	
Chargeable gain on premises	no gain/no loss	
Income gain on goodwill	no gain/no loss	
Tax charge on shareholder, if there is a formal winding up and therefore a capital distribution	**£**	
Distribution (£15k+£9k-capital treatment as < £25k)	24,000	
Less: annual exemption	(10,600)	
CGT (assuming Entrepreneurs Relief conditions satisfied)	13,400	at 10% = **£1,340**
Total tax	**£1,340**	
Tax saving at the point of disincorporation	**£19,200**	

D.11 In this example, the introduction of a disincorporation relief would create a tax saving at the point of disincorporation of £19,200. Further, there is no longer a need to wind up the company formally, saving liquidator's fees.

D.12 The business is now in an unincorporated form, and will incur additional annual tax charges. On profits of £25,000 per annum, he may pay up to £1,500 extra per annum in income tax and NICs following disincorporation.

D.13 There will be a tax charge at the point of sale or cessation of the business. For example, after a further 5 years the business is sold, with equivalent values to those at the point of disincorporation. The capital gain on Derek is as follows:

	£	
Premises (£150,000 – £100,000)	50,000	
Goodwill (£80,000 – £32,000)	48,000	
	98,000	
Less annual exemption, say	(12,000)	
CGT (assuming Entrepreneurs' Relief conditions satisfied)	86,000	at 10% = **£8,600**

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This document can be found in full on our website at:
http://www.hm-treasury.gov.uk/ots

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