Office of
Tax Simplification

Disincorporation of small companies:
a discussion paper

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ISBN 978-1-84532-887-0
PU1196

Preface

Subject of this consultation	To determine whether or not there is a need for a relief that would allow companies to disincorporate without there being a significant tax disadvantage and to consider the possible form of any such relief.
How did the OTS get to this stage?	This paper builds on the OTS's interim report on small business tax that was published on 10 March 2011. The interim report was informed by a series of workshops with small business held across the UK.
Scope of this consultation	The consultation seeks views on the need for simplification in this area of taxation and on the desirability of each of the options.
Who should read this?	Proprietors of small companies; advisers to small companies; representative bodies.
Duration	The consultation will run for 10 weeks from 28 July 2011. The closing date for responses is 7 October 2011.
How to respond	Responses should be sent via email to: OTS-SmallBusiness@ots.gsi.gov.uk Alternatively, please use the postal address: Review of small business tax Office of Tax Simplification 1 Horse Guards Road London SW1A 2HQ
Additional ways to be involved	As part of this consultation, the OTS will be hosting a series of meetings and workshops in September and October 2011. We welcome offers for meetings from interested parties.
After the consultation	The work on relief for disincorporation is part of the second stage of the OTS review of small business tax. The final report will be published before Budget 2012. Between the end of this consultation and publication of the final report, the OTS will refine options and develop the evidence base to support any recommendations. The OTS is an advisory body and it will be up to the Chancellor to decide whether or not to take forward our proposals. If he does, then we would envisage a further period of more detailed consultation and the publication of draft legislation, in line with the Government's approach to tax policy making.

Contents

Executive summary

The remit for the Office of Tax Simplification ("OTS") in relation to small business taxation includes providing recommendations to the Chancellor on areas of complexity and uncertainty for small businesses. During the course of the research we carried out for the first stage of our work in this area, one problem that was identified in both meetings and representations related to the ability for businesses to choose the legal form in which they operate without being disadvantaged from a tax perspective. Reliefs apply to individuals on incorporating their business, so that no charge to capital gains tax need arise on the transfer of assets into the company, but there are currently no reciprocal reliefs on 'disincorporating'. This was listed as an area for review in the OTS interim report paper[1].

The issue of a tax relief for companies that wish to change their legal status (referred to here as a disincorporation relief or reliefs) has been considered in the past. It was the subject of a joint Inland Revenue/Department of Trade and Industry consultation in 1987 but was not taken forward; it has been returned to periodically by representative bodies since then but no progress has been made.

It seems appropriate to review the issue afresh now, in the light of today's situation, in particular the volume of small businesses that incorporated to take advantage of the 0% corporation tax rate that used to be in place. Arguably many of these businesses would be better off returning to unincorporated status, to save administrative burdens. Against that, the decision to incorporate was taken to obtain a tax advantage so there is an argument that all consequences should follow. In any event, the point is regularly made that current tax and national insurance rates do, if anything, encourage businesses to incorporate and so it is questionable whether there is currently a real demand for this potential new relief.

There is a concessionary form of disincorporation relief available through extra-statutory concession C16, which allows companies a simplified striking off procedure without the need for a formal liquidation. HM Revenue & Customs ("HMRC") is consulting on the best way to replace this concession with a view to legislation in 2012. The OTS is following this consultation with interest and is discussing with HMRC how best to take into account any emerging conclusions from our review into a possible disincorporation relief.

We have been assisted in developing this discussion paper by both HM Treasury and HMRC, as well as by members of our Consultative Committee and representations received. A number of Committee members have challenged us on whether there is a need for a disincorporation relief and assessing potential demand is a key objective of this consultation.

The paper raises a complexity challenge: would the additional complexity of tax law caused by introducing a disincorporation relief outweigh the administrative and legislative simplifications for businesses taking advantage of the relief? The paper also identifies a potential issue with eligibility: what sort of companies would qualify for a disincorporation relief? The OTS has proceeded on the basis that any relief would be available to companies carrying on a trade; but how far should any such relief be extended to companies with other businesses, such as property investment companies? The paper generally uses the term 'business' in developing its

[1] "Small business tax simplification review: interim report" OTS, March 2011, http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

arguments, but any recommendation to proceed with a disincorporation relief will need to define eligibility.

In summary, this is a discussion paper to bring together previous considerations and examine the level of demand for such a relief at the present time. We invite comment on what factors might lead a company to want to make the commercial decision to disincorporate, and for each of those, what tax barriers currently exist. It is not a recommendation from the OTS for the introduction of a disincorporation relief: whether such a recommendation is made depends on the responses we receive.

1 Introduction

1.1 The Office of Tax Simplification published its interim report on small business taxation in March 2011[2], which identified the issue of a disincorporation relief. That was informed by views and representations from small businesses. This paper considers whether there is a need for a disincorporation relief, or a package of reliefs, as well as looking at possible forms for the relief.

1.2 There is no legal definition of "disincorporation"; it is not synonymous with liquidation or winding up. In this paper a business is 'disincorporated' where a company transfers its business and assets to the shareholders. Following the transfer, a dormant company shell remains which may be retained (e.g. to preserve the name), liquidated or struck off. The tax aspects of disincorporation are linked with wider considerations of the structure and administrative requirements relating to small businesses.

1.3 In 1987, following representations that there were fiscal and legal deterrents to moving from an incorporated status to an unincorporated status, a joint Inland Revenue/Department of Trade and Industry consultative document was issued[3]. The aim was to change the law to "make it easier for businesses to switch from trading as limited companies to sole traders or partnerships" and thereby reduce the costs (including tax) which "attach to disincorporation and effectively rule it out as a practical option". The consultation was subsequently referred to by Sir William Clark MP in the debate on the 1990 Finance Bill[4] and again in 1993, by the then Financial Secretary to the Treasury, Rt Hon Stephen Dorrell MP in a reply to a letter from Sir John Hannam MP.[5]

1.4 The idea of some form of relief for disincorporation was revisited in the 1996 DTI report "Competitiveness – forging ahead"[6] which stated that "the Government ... has started work on disincorporation". In March 2000 the Paymaster General, Rt Hon Dawn Primarolo MP, stated that there would need to be a very strong case for a disincorporation relief due to the length and complexity of the legislation required, and that, following representations, "no strong case for change has so far emerged".[7]

1.5 Following the introduction of limited liability partnerships ("LLP") in 2000 and the introduction of the 0% corporation tax rate in 2002 and subsequent repeal in 2006, disincorporation once again became an issue.

1.6 The tax charges that can arise on companies that choose to disincorporate have been considered in a number of articles and academic papers including "The Economic, Legal and Taxation Effects of Disincorporation" by Gordon Channon, Ali Edwards and Simon James (2001)[8].

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[2] "Small business tax simplification review: interim report" OTS, March 2011, http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

[3] "Disincorporation – a consultative document" Inland Revenue/Department for Trade and Industry (1987)

[4] Hansard, HC Deb, 26 March 1990, Vol 170, c45 - 90

[5] http://business-school.exeter.ac.uk/documents/papers/management/2001/0106.pdf

[6] 1996, see Chap 15 paragraph 13

[7] Hansard, HC Debates 29 March 2000 Vol 347 c149w

[8] http://business-school.exeter.ac.uk/documents/papers/management/2001/0106.pdf

1.7 The matter was raised in the debate on the 2008 Finance Bill[9], but this is the first paper since then to consult on the issues in order to gauge demand for the introduction of a new relief to facilitate disincorporation.

1.8 The situation of the small businesses that incorporated to take advantage of the 0% corporation tax rate is fairly clear. They did follow an established route, with clear tax reliefs, to get to a tax advantaged position. It may be that they would be better acting now as unincorporated again to save administrative burdens and professional fees. But, as has been shown in previous papers on the subject, there is no established procedure to facilitate this except ESC C16 (see paragraph 3.8), which does not remove tax barriers to disincorporation.

1.9 The introduction of LLPs adds a further dimension. Where an LLP is carrying on a trade or business, members of the LLP are taxed as if they were partners in a partnership, although the entity is established as a body corporate. The provisions of the Limited Liability Partnerships Act 2000 allow a partnership to convert to an LLP on a tax-neutral basis, but there are no provisions in the Act providing tax neutrality where a company transfers its trade to a partnership[10], which a disincorporation relief could facilitate.

[9] Hansard, HC Deb, 28 April 2008, Vol 475 c34

[10] Hansard, Session 1999- 2000, Standing Committee F, 15 June 2000, Dr Kim Howells MP

2 Why introduce a disincorporation relief?

2.1 Small businesses are able to operate in different legal forms, e.g. sole trader, limited company, partnership or LLP. Each legal form brings advantages and disadvantages that need to be weighed up by the business in order to operate through the most suitable form. Operating through a limited company brings more regulation, greater administrative burdens and higher professional costs (which we explore later in this chapter). On the other hand, advantages of operating through a limited company include greater prestige for the business, the availability of limited liability, a greater ability to raise money for capital investment and more flexibility in selling the business. In practice however, many businesses do not need these benefits, especially if they do not wish to grow, invest or borrow.

2.2 It is therefore possible that some small companies are not operating through their optimal business structure and are incurring extra costs and burdens for little additional benefit. However, at the moment, there are sometimes significant potential tax barriers standing in the way of small companies that wish to change to operating through an unincorporated structure. We have heard of businesses that feel trapped in their corporate structures with no easy way out.

2.3 A complicating factor is that tax is currently a major consideration in deciding whether or not to operate through a company (see table 2.A). We believe that many businesses incorporated to take account of the 0% corporation tax rate between 2002 and 2006, but some may not have fully thought through the implications, and now find themselves facing all the disadvantages of a corporate structure without really needing the benefits associated with operating through a limited company.

2.4 Many businesses will want to continue operating through corporate structures because of the tax and national insurance advantages, which often outweigh the additional burdens and costs of operating through a company. However, we believe that there are some small businesses for whom the additional burdens and costs outweigh the tax and other benefits. For such businesses the ability to revert to operating as sole traders or partnerships might provide long term simplification.

2.5 There are tax reliefs for businesses that incorporate[11], but no equivalent provisions exist allowing for disincorporation without a tax charge. Disincorporation relief could provide broadly equivalent provisions to those that allow incorporation without an immediate tax charge (e.g. by rolling or holding over the chargeable gain), and would provide a form of symmetry of taxation as businesses move to the legal framework that is most appropriate.

2.6 Disincorporation relief would be a move towards lightening the administrative burden on taxpayers[12]. For tax obligations, the OTS has estimated that, on average, small singleton companies face double the administrative burden of comparable small unincorporated

[11] In particular s162 TCGA 1992 and s87 ITA 2007.

[12] See, for example, Budget Speech 2011 and Red Book 2011, paragraph 2.200 ("Customer cost reduction announcement")

businesses[13]. If a company is struck off or dissolved, that removes the need to comply with company law requirements.

What are the views of taxpayers?

2.7 The idea of a disincorporation relief was mentioned regularly by small businesses and representative bodies during the roadshows that formed part of the initial research for the interim report of the small business review. The general point was that a form of disincorporation relief may be welcomed by businesses that incorporated for tax reasons, and now find themselves without the anticipated tax benefits but with a disproportionate administrative burden. However, members of the OTS consultative committee for the small business review have divergent views on the demand or indeed desirability of such a relief.

2.8 In preliminary discussions with some firms of tax advisers about real life companies, the OTS has identified three main situations where a disincorporation relief might be desirable:

- The company with little or no value in capital assets, probably a one person operation, which could carry on as a sole trader.
- A slightly larger business, perhaps husband and wife or wider family, which has goodwill and so may benefit from a narrow form of relief, ensuring a tax neutral transfer across to the disincorporated trade, probably continued as a partnership.
- A larger company with capital assets as well as intangible assets may need a wider form of relief, to enable a claim to hold-over the chargeable gains on transfer of the assets to the disincorporated trade, which may be carried on as an LLP or as an unincorporated business or partnership.

There are also capital gains tax issues for the shareholders in all cases, though only in the last situation are these likely to be significant.

2.9 This paper aims to explore whether there is a real demand for a disincorporation relief. It reviews the largely anecdotal information on the need for a disincorporation relief, and aims to gather evidence on the commercial, administrative and economic issues that may drive a company to want to disincorporate, and the issues and barriers they are experiencing in doing so.

2.10 At this stage, it has not been possible to ascertain the number of disincorporations over time, given the difficulties with linking the "death" of a company to a business that continues as an unincorporated business. The evidence collected via this discussion paper will enable a more detailed assessment of the demand for disincorporation.

Questions for consultation:

1. What are the drivers for a company to disincorporate its business? Is it simply a question of administrative savings?

2.11 There are other measures under consideration to assist small businesses, which include:

- The Department for Business, Innovation and Skills ("BIS") and the Financial Reporting Council are considering new reporting requirements for micro entities,

[13] Based on initial OTS analysis of the 2005 KPMG admin burdens data for representative businesses with turnover between £1-£750,000 per annum. However, there have been a number of changes to administrative burdens and compliance costs since 2005. The OTS plans to conduct further analysis of the difference in administrative burden for companies and unincorporated businesses.

which, if introduced, should ease the burden on companies, thereby reducing the desire to disincorporate the business; and

- Alongside this, BIS is also considering the introduction of a new business entity, the single person corporate form.

2.12 Both propositions are still in their early stages and the OTS will continue to monitor developments and their impact on our small business review.

Reasons why businesses change legal form

2.13 There are many reasons why a business may incorporate, including:

- limited liability, although as creditors often require a personal guarantee from the directors, this is not always a real advantage;
- credibility;
- existence of the company independently from its shareholders;
- separation of ownership and management;
- ability to reward employees through share schemes;
- commercial reasons (for example for some commercial contracts a corporate structure may be a condition of the contract);
- prestige; and
- tax – both potential tax savings and 'insulating' clients/customers from employment tax issues.

2.14 There are both benefits and burdens from operating as an incorporated entity, with the disadvantages including increased regulation, which may well lead to increased professional fees.

The tax question

2.15 The question whether a business would be better off from a tax perspective by operating through a limited company has been posed to advisers for many years. With changes in tax rates, the answer fluctuates and the eventual recommendation to the business normally depends on circumstances, intentions and more than simple tax numbers. However, in recent years, the pure tax answer has usually been that incorporation offers a lower tax bill. The main differential is through dividends not being subject to NICs.

2.16 There was a huge rise in tax motivated incorporations for the smallest businesses[14] following the introduction of the 10% "starting rate" of corporation tax in 2000[15] and, more significantly, its subsequent reduction to 0% in 2002[16].

2.17 Table 2.A below shows how the tax incentive to move from a sole trader to a company has changed over time, given certain important assumptions. The amount of tax saving (in nominal terms) in each year for each level of taxable profit has been calculated. This is shown as a proportion of the saving in 2002-03 for that level of taxable profit. For example, the data shows that for an individual with taxable profit of £40,000 per annum, the tax saving from incorporation in 2010-11 was 64% of the saving that was available in 2002-03. The table shows

[14] See for example Rt Hon Gordon Brown MP, Budget Speech 2004

[15] FA 1999 s29

[16] FA 2002 s32

that the biggest fall in the size of the incentive since 2002-03 has been for businesses with the lowest taxable profit.

Table 2.A: Initial OTS analysis of changes in the incentive to incorporate from self-employment

Taxable profit per annum	Size of the tax incentive for incorporation over self-employment as a proportion of the incentive in the 2002-03 tax year[17]						
	1998-99	2000-01	2002-03	2004-05	2006-07	2008-09	2010-11
£10,000	24%	64%	100%	42%	28%	26%	23%
£20,000	37%	69%	100%	60%	49%	35%	34%
£30,000	46%	73%	100%	80%	73%	50%	48%
£40,000	44%	80%	100%	102%	93%	65%	64%
£50,000	45%	81%	100%	113%	117%	98%	107%
£60,000	44%	81%	100%	120%	125%	102%	110%
£70,000	41%	79%	100%	122%	127%	100%	108%
£80,000	38%	77%	100%	125%	130%	99%	107%
£90,000	36%	76%	100%	127%	132%	97%	105%
£100,000	33%	74%	100%	129%	134%	96%	104%

Notes:

- Underlying values are in nominal terms, and therefore understate the size of the incentive in earlier years.
- Remuneration from incorporation has been modelled with the following assumptions:
  - One director
  - Remunerated with 100% dividends above the income tax personal allowance
  - No employers National Insurance Contribution on salaries for directors
  - 0% private pension contribution from company earnings

2.18 The previous Government aimed to reduce the tax and NI advantages from incorporation. 'Tax motivated incorporations' were tackled, first with the introduction of the 19% non-corporate distribution rate[18] on distributions made to individuals between 1 April 2004 and 31 March 2006[19] and then the repeal of the 0% rate from 1 April 2006[20]. The small profits rate of tax was increased, though the plan to move to a 22% rate was not proceeded with and indeed the rate has now reduced to 20% (for the financial year commencing 1 April 2011)[21].

2.19 However, the recent rise in rates of national insurance, coupled with the reduction of the corporation tax rate to 20%, incentivises incorporation. This may reduce the current demand for a disincorporation relief.

2.20 Traders who previously incorporated their businesses can find themselves facing additional tax costs, for example, Class 1A NICs and personal income tax on company cars, though the difference between this and operating a car as a sole trader can be marginal. The incorporated sole trader may have to deal with payroll administration for the proprietor as well as having to keep the business and personal banking separate (although that is no bad thing for an unincorporated business as well). The need for company tax returns to use iXBRL format for

[17] The size of the incentive in 2002-03 was approximately £1,500 at £10,000 taxable profit, £3,000 for £20,000 taxable profit, and then between £3,500 and £3,800 for the higher levels of taxable profit in this table. The year 2002-03 is taken as the 'benchmark' because of the existence of the 0% corporation tax rate.

[18] FA 2004 s28

[19] Repealed FA 2006 s26(2)

[20] FA 2006 s26(1)

[21] FA 2011 s6

accounts and computations has been raised with the OTS as an additional administrative burden.

2.21 In addition to these tax issues, there are also administrative burdens imposed on an incorporated entity by Companies Act 2006 ("CA 2006"), including:

- preparation and filing of the annual return;
- preparation and filing of annual accounts;
- annual audit which although not mandatory for "small" companies[22], may be desirable e.g. if loan finance is being sought; and
- maintaining records of resolutions and minutes of board meetings.

2.22 In practice, many of these requirements may be outsourced to an external accountant, thereby incurring additional professional fees. We understand that the typical professional accountancy and taxation fees for preparing accounts and tax returns for a company are greater than the fees for preparing accounts and tax returns for an equivalent unincorporated business. The OTS intends to carry out some analysis to try and quantify these extra tax and accountancy costs. Clearly, in many cases, the business would wish to call on accounting assistance and to have proper accounts, whatever the legal form of its activities.

2.23 The decision to incorporate can be driven by factors away from tax savings or administrative burdens. A company can issue shares – offering the possibility of giving an interest to some employees that falls short of a partnership. A company is often seen as having more permanence and prestige, thus offering an intangible advantage in business. Very importantly in the contracting world, a company offers 'insulation' for the larger businesses that hire the freelancer/contractor against employment rights claims and against possible HMRC claims that the individual was in fact an employee rather than self-employed. Freelancers and contractors sometimes have no choice but to incorporate, as many employment agencies only place incorporated work seekers.

Is there a demand for disincorporation?

2.24 The OTS has not found any current survey evidence to assess whether there is a desire for companies to move back to unincorporated status, and if so, what the barriers are. Surveys[23] were undertaken in the mid-1990s that indicate that:

- the owners of some limited companies considered that the disadvantages of disincorporation outweigh the advantages;
- some directors considered that the decision to incorporate was a mistake;
- where businesses changed their legal form over a period of time, the progression was usually from sole trader to limited company, possibly via a partnership; and
- tax was not considered to be a major factor preventing a change from incorporated to unincorporated entity; of greater significance were loss of prestige and the provision of security.

2.25 However, these surveys predate factors such as the 0% corporation tax rate, simplified audit requirements, LLPs and the simplified striking off procedure. This paper seeks to gather further and more recent evidence.

[22] A small company meets two of the following three tests in the current and preceding financial years – turnover ≤ £6.5million; balance sheet total ≤ £3.26million; and ≤50 employees.

[23] http://business-school.exeter.ac.uk/documents/papers/management/2001/0106.pdf

Questions for consultation:

2. Are there further significant factors that influence the incorporation decision (other than those listed above) that need to be considered in the context of a disincorporation relief?

3. What evidence is there that businesses would wish to disincorporate? Are there particular categories of business that would wish to take the route?

3 Current tax implications of disincorporation

3.1 Disincorporation, for the purposes of this paper, involves a transfer of a business from a company to its shareholders, but does not need to involve the striking off or liquidation of the remaining company. That can be left dormant or used for other purposes.

3.2 The legal issues surrounding the winding up of the company following a disincorporation of a business are considered in Annex C to this paper. It is anticipated that most disincorporations would lead to the company being wound up in one way or another – so a simple tax procedure for disincorporation should work together with a simple company law procedure for eliminating the company.

Question for consultation:

4. 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?

3.3 The main tax consequences of disincorporation are set out in Annex A, with a worked example in Annex B.

The old company

3.4 The main tax consequences for a small company transferring its business to its shareholders are likely to be a charge to corporation tax on the transfer across of intangible assets such as goodwill, (whether under the intangible assets regime or a chargeable gain on pre-April 2002 goodwill) and a chargeable gain on other chargeable assets; whilst capital gain rollover provisions exist where a business incorporates[24], there are no equivalent provisions that apply when a business disincorporates.

3.5 Additionally any trading and other losses will be lost, although the company may be able to utilise terminal loss relief, so that the loss from the last accounting period can be set against profits for previous accounting periods.

3.6 The literature on disincorporation cites the impact of capital gains as being a major barrier. A limited survey of accountants[25] carried out in 1997/98 identified 11 actual companies that their advisers felt should disincorporate, but were prevented from doing so because of tax barriers. Of these 11 companies, their accountants thought 10 would disincorporate if there was a form of rollover relief for the capital gain arising on disincorporation.

[24] See s162 & 162A TCGA 1992
[25] http://business-school.exeter.ac.uk/documents/papers/management/2001/0106.pdf

The shareholders

3.7 Normally where a company's assets are transferred to its shareholders for no consideration then the market value of the assets is taxable on the recipients as an "income distribution" at the dividend tax rate – 10% for income up to the basic rate limit, 32.5% for income above the basic rate limit and 42.5% for additional rate taxpayers. If the company is formally wound up, then any distribution by the liquidator to shareholders is taxable on the recipients as a capital distribution, which is charged to capital gains tax. Entrepreneur's relief would be available in the case of small trading companies, so the gain would be taxed at 10%, subject to certain qualifying conditions.

3.8 For companies wishing to avoid the expense of appointing a liquidator, HMRC has for some time offered an alternative route, extra-statutory concession ("ESC") C16. This concession provides that where certain assurances are given and certain conditions are met, a distribution made by a company that has ceased business and is awaiting dissolution may be treated as though it had been made in a formal winding up. This means the distribution is treated as a capital distribution, chargeable to capital gains tax with entrepreneur's relief possibly available. HMRC is conducting a consultation aimed at legislating ESC C16 as part of its programme of reviewing extra-statutory concessions following the House of Lords decision in the Wilkinson case[26].

3.9 An alternative method of winding up the company is through a members' voluntary liquidation, but this would incur liquidation fees. Shareholders will suffer capital gains tax on the excess of the distribution received over the base cost of their shareholding. Other tax implications may include a benefit in kind charge on any assets transferred to the shareholders if they are also directors.

The continuing business – other tax issues

3.10 For capital allowances purposes, a writing down allowance is not available in the accounting period of a company in which a trade ceases. Instead, a balancing allowance or charge arises. However, a joint election[27] between the company and the shareholders continuing the trade will enable a tax neutral transfer at tax written down value to take place.

3.11 Similarly, an election is already available to enable stock to be transferred on a tax neutral basis.

3.12 For a VAT registered business, if the transfer of going concern provisions ("TOGC")[28] apply, no VAT will be levied on the transfer and both parties may elect for the existing VAT registration to be carried over to the successor to the business.

3.13 For the business, the transfer of the business and assets from the company to the successor will end an accounting period and may accelerate the due date for payment of tax if this is not done at the year end. For a sole proprietor, tax will be payable on 31 July and 31 January, and in the first year after disincorporation this may adversely affect cash flow.

3.14 For the Exchequer, if gains are rolled over, this will delay the crystallisation of the tax charge and will, on the surface, result in a cash flow disadvantage. However, in many cases the existence of such a potential tax cost would preclude any action that might crystallise the tax charge.

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26 R v HM Commissioners of Inland Revenue ex parte Wilkinson (2005) UKHL 30

27 CAA 2001 s266

28 VAT (Special Provisions) Order 1995, Article 5.

3.15 The rights of employees where the business changes ownership, which would occur on a disincorporation, are protected under the Transfer of Undertakings (Protection of Employment) law (TUPE)[29].

Questions for consultation:

5. Are there any significant further tax or general issues on disincorporation other than those listed above that need to be considered?

[29] Statutory Instrument 2006 No. 246

4 Which companies may benefit from a disincorporation relief?

4.1 Before considering potential features of a disincorporation relief, consideration must be given to which companies may benefit were such a relief to be introduced, to ensure that the measure is properly targeted and opportunities for abuse are minimised.

4.2 Some examples of companies that may benefit from a disincorporation relief are as follows:

- Businesses that incorporated for tax reasons and now find that the administrative burdens outweigh the tax benefits. It would remove a barrier allowing businesses to be converted to the most appropriate form without tax implications, and would enable the businesses to focus on growing or running the businesses.
- Sole traders who wish to incorporate may be reluctant to do so in the absence of a mechanism to disincorporate subsequently, allowing the business to operate through the most appropriate business entity. The lack of a disincorporation relief may therefore be a barrier to incorporation as businesses fear becoming trapped in the corporate form.
- Incorporated businesses that wish to convert to a LLP, which may be the most appropriate structure for some growth or entrepreneurial businesses, which may wish to bring in partners into the business rather than use shares[30].
- Established companies facing shareholder disputes or succession issues, where the business needs to be fragmented and remaining part(s) would be more suited to unincorporated status. Disincorporation may mean considerable chargeable gains arising both on the company, and the shareholders[31].
- Long established companies holding significant capital assets, with reducing trading activity, but where the chargeable gains rules on the company and the shareholders prevent disincorporation.

Questions for consultation:

6. Do the five examples above correctly identify situations where a disincorporation relief may be commercially desirable? Are there any further examples?
7. Should investment companies, including property investment companies, be excluded from any disincorporation relief?

[30] Though current share-based incentives, in particular the Enterprise Management Incentive would normally mean that the corporate route is more attractive in such situations.
[31] There is of course demerger relief which is used to tackle such situations but that relief requires the businesses to stay in corporate form.

4.3 As the rationale behind the relief would be to assist small businesses that had incorporated (whether or not for tax reasons) and are now having to comply with the additional administrative burden that incorporation involves, the target population is clearly a subset of small companies. Further definition of the companies to which this relief would attach is required to ensure that the correct population is being assisted. There already exist two structural definitions:

4.4 The EU definition of a micro business[32] is as follows:

- Number of employees , <10; and either
- Turnover $\leq$ €2 million; or
- Balance sheet total $\leq$ €2 million.

4.5 The Companies Act 2006 definition of a small company[33] requires that two out of the following be satisfied:

- Number of employees $\leq$ 50;
- Turnover $\leq$ £6.5 million; and
- Balance sheet total $\leq$ £3.26 million.

4.6 The EU micro company definition would ensure that any relief would be more closely targeted at the population that it is intended to benefit, whereas the CA 2006 definition would make the relief available to a much wider population than might be desirable.

4.7 The 2001 Exeter University research[34] paper suggests a typical company affected by the lack of disincorporation relief is one that has turnover $<$ £350,000, balance sheet total $<$ £975,000 and on average fewer than 50 employees. However, as the paper predates the introduction of the 0% tax rate in 2002 and the Companies Act 2006, its findings need to be treated with caution.

Question for consultation:

8. What would be the best way to define the size and type of companies that should benefit from a possible disincorporation relief?

[32] http://europa.eu/legislation_summaries/enterprise/business_environment/n26026_en.htm

[33] Companies Act 2006 ss 382

[34] http://business-school.exeter.ac.uk/documents/papers/management/2001/0106.pdf

5 What might a disincorporation relief look like?

5.1 It is important to be clear that the OTS is not making proposals for a disincorporation relief at this stage. The aim of this chapter is to present some provisional options in enough detail to help people gauge whether there is a demand for such a relief and whether it would deliver overall simplifications for small businesses.

5.2 The OTS has approached the design of a possible disincorporation relief by looking at some categories of companies that might benefit from a relief, and then tailoring different forms of relief to these categories. Bearing in mind the need to balance a range of factors such as simplicity, cost of the relief to the Exchequer and the potential impact on avoidance and evasion, we have looked at options that provide a narrow form of relief alongside options that provide a wider range of reliefs.

5.3 The five examples of companies that may benefit from a disincorporation relief listed in paragraph 4.2 of the previous chapter broadly fall into one of the two following categories:

1. Small companies with just one or two owner/manager(s). The company is likely to have few capital assets but there may be goodwill associated with the business that may or may not be reflected in the accounts.
2. Small companies with more than one shareholder/manager which have capital assets such as property or plant, and may also have built up goodwill over time, which may or may not be reflected in the accounts.

5.4 It is possible for a company in category 1 to (in effect) disincorporate with no tax barrier, provided ESC C16 is used and certain assurances are given to HMRC before the company is dissolved. Using ESC C16, they do not need to pay the fees of a liquidator, and any distribution of money or assets from the company is treated as a capital distribution, chargeable to capital gains tax on the recipients. If there are no assets transferred to the shareholders then there is no chargeable gain on the company.

5.5 The transactions in securities anti-avoidance legislation[35] would not normally apply to commercial disincorporations.

5.6 This chapter proposes options for tax reliefs. But the OTS considers that whatever option is agreed to be appropriate, a disincorporation relief necessarily goes hand in hand with a simplified administrative process. This would need to be explored in the context of the current HMRC consultation into ESC C16, which the OTS is following closely. In particular, the suggestion that the legislative replacement for ESC C16 be restricted to a £4,000 limit for capital distributions is a significant factor.

[35] Part 13 ITA 2007

Option 1 – Narrow form of capital gains relief

5.7 Some companies under category 1 above will have internally generated goodwill, which may have been transferred from the previous unincorporated business. If the original business came into existence after 31 March 2002, or was acquired from an unrelated party after that date, the goodwill will come within the tax regime for corporate intangibles. Any goodwill arising on such a business is calculated in accordance with generally accepted accounting principles. If a business is transferred from the company to its shareholders then the market value of the goodwill is brought into account[36] and where it exceeds the goodwill value written down in the company accounts, the excess is charged to corporation tax[37].

5.8 A possible narrow form of disincorporation relief might be to allow the goodwill arising on the transfer of a business to be transferred from the company to the shareholder(s) carrying on the successor business at a value that would not give rise to a corporation tax charge on the company. The goodwill would then eventually be chargeable to capital gains tax on the person(s) running the successor business when they disposed of it.

5.9 For pre-April 2002 goodwill, a chargeable gain (using market value at transfer, but allowing for indexation relief) is currently chargeable to corporation tax. Here a possible narrow form of disincorporation relief might be to allow a hold-over of the gain into the new business. To simplify the administration, consideration should be given to HMRC using the approach outlined in Statement of Practice 8/92 where market value at disposal need not be agreed with HMRC in certain circumstances where holdover relief is available. An alternative approach would be for the shareholder(s) to be deemed to acquire the assets at a value producing no gain or loss.

5.10 If the goodwill is acquired by the shareholder(s) for no consideration then there would be potential income tax liabilities under company distribution and employee benefit rules that would need to be considered in designing a relief.

5.11 Valuing goodwill is complex, so ideally any proposal for a disincorporation relief should not require this.

Option 2 – Wider form of relief

5.12 Companies under category 2 in paragraph 5.3 above are likely to hold chargeable assets as well as goodwill. The main tax barrier to disincorporation here is the chargeable gains tax charge for the company and the income tax or further capital gains for the shareholders. The aim[38] of any wider disincorporation relief would be to eliminate both levels of immediate taxation.

5.13 The suggested features of this option, in addition to the simplified administration already outlined at paragraph 5.6, are as follows:

- **Chargeable gains on assets** – on incorporation TCGA 1992 ss 162 and 165 provide a deferral for gains on tangible assets transferred to the company, the rationale being that the economic interest in the assets is the same before and after the transfer and so to impose a tax charge would be inequitable . A similar deferral relief is proposed for disincorporation under which chargeable gains arising to the company on the transfer of assets to the individual is rolled over against the acquisition cost of assets in the shareholder's hands. An alternative approach would be for the shareholder(s) to be deemed to acquire the assets at a value producing no gain or loss.

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[36] Corporation Tax Act ("CTA") 2009, s845

[37] CTA 2009, Part 8 Chapter 4

[38] See, for example, "Disincorporation" Inland Revenue/ Department of Trade and Industry, 1987

- **Goodwill and intangible assets** – the narrow relief under option 1 would apply here.

- **Tax treatment of shareholders** – the shareholders will potentially have gains arising on the capital distribution by the company, unless income distribution rules apply, possibly through HMRC successfully applying the transactions in securities legislation. To eliminate the second layer of taxation at the shareholder level, it is proposed that this gain be deferred until the former shareholders dispose of their interest in the successor business.

5.14 Clearly there is scope here for substantial gains to be deferred with the risk that the tax due would never be paid. The risk of this procedure being abused would need to be protected against if it is taken forward, so some anti-avoidance provisions would be needed, or at a minimum a 'bona fide commercial purpose' test.

Other potential tax issues

5.15 In addition to the chargeable gains arising on disincorporation, some companies in the second category, and other long established companies may encounter other tax issues, such as capital and trading losses, benefits in kind, and stamp duty land tax.

5.16 These further issues are as follows:

- **Unrelieved trading losses** – relief for trading losses of an unincorporated business can be set against income derived from the company[39]. On disincorporation, it is not possible to carry trading losses forward from the company into the successor trade. However, terminal loss relief is available to take the loss back against total profits and gains of the preceding three years. Alternatively, a relieving provision could enable trading losses to be transferred to the successors to the business in proportion to their shareholdings to the business, to be used against profits of the same trade. This provision would need to be subject to certain conditions, e.g. that there is no major change in the nature and conduct of the trade following the disincorporation; alternatively, streaming rules could be required, but this would add complexity.

- **Unrelieved capital losses** – it is not proposed that there should be any carry forward of allowable capital losses from the company to the successor to the business, and that capital losses should remain in the legal entity in which they arose. It may well be that they could be used up against gains on assets being moved out of the company, instead of those assets moving with held over gains.

- **Other losses** – excess management expenses and unused property business losses could also be carried over.

- **Stock and work in progress** – will automatically be transferred to the disincorporated entity at the lower of cost and net realisable value[40];

- **Capital allowances** – the existing joint election for assets to which capital allowances attach to be transferred at tax written down value[41] should be extended to apply automatically for disincorporations.

- **VAT** – the existing provisions for VAT need no amendment.

[39] s86 ITA 2007
[40] CTA2009 s167.
[41] CAA 2001 ss265 – 267A

- **Stamp duty land tax** – Where the business holds land and property, there will be a potential charge to stamp duty land tax on the transfer. However, this may be avoided by distributing the property in specie to the shareholder during a winding up. That argues for an extension of this relief to all transfers of the property on disincorporation.
- **Transactions in securities** – The provisions of ITA 2007 Part 13 Ch. 1 will not normally apply to ordinary disincorporations[42]. Consideration is given in the next chapter as to whether there is a need for anti-avoidance legislation to prevent unintended behaviours.
- **If assets are passed to shareholders** for no consideration, a benefit in kind charge will currently arise on the shareholder, if he or she is also a director or higher paid employee, based on the cost to the company, unless this is already treated as an income distribution. This needs to be eliminated, on the basis that the future use by the shareholder will produce taxable income.

Questions for consultation:

9. 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?
10. 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?
11. Is there evidence that any of the further tax issues listed, outside the narrow and wider options for relief, are preventing companies from disincorporating?
12. Would the 'wider' relief be open to abuse? If so, how? Would a bona fide commercial test be sufficient to protect the revenue? Would the protection need to go further, such as the chargeable payments rules in the demerger relief[43]?

[42] Joiner v CIR [1975] STC 657
[43] CTA 2010 s1088

6 Would a disincorporation relief be a simplification?

6.1 The rationale for a disincorporation relief is to remove the barrier to moving away from limited company status, thereby allowing incorporated businesses to operate in the optimal business form. The advantages of a disincorporation relief include the alleviation of a significant administrative burden on businesses that incorporated for tax reasons, but would now find it beneficial to operate as an unincorporated entity.

6.2 There are a number of issues to consider in relation to a disincorporation relief, to ensure that it operates as intended, and does not give rise to tax avoidance or evasion. These may give rise to lengthy and complex anti-avoidance legislation; this must be considered in the light of the OTS's aim of simplifying the tax legislation. Any legislation must also be proportionate to its aim.

Additional reliefs in the legislation

6.3 Depending on the form of the relief adopted it would introduce at least one additional relief in legislation and possibly more (e.g. if relief were to be provided for trading losses as well as for chargeable gains). The first completed project undertaken by the OTS was a review of reliefs[44], which had as one of its aims reducing the number of tax reliefs. Introducing additional reliefs is contrary to this, and any additional reliefs would have to be assessed to ensure that the simplification benefits outweigh the complexity of the additional legislation required.

6.4 The Government has announced that it is drawing up a framework with which it will consider proposals for new tax reliefs[45]. Any proposal for a new relief for disincorporation would need to be considered within this framework.

6.5 Consideration should be given to whether the relief needs to be a permanent or temporary relief. A permanent relief might be more costly for the Exchequer and be vulnerable to tax avoidance. These risks could be mitigated by a time limited relief operating for say a year or two. This would give a "window" for current small companies to disincorporate.

6.6 However, the problem of businesses incorporating for tax reasons is likely to continue as long as there is a tax incentive to do so, and some of these businesses may not have fully thought through the implications and want to change their minds. This is likely to generate pressure to extend or remove any time limited window for a disincorporation relief.

Drafting issues

6.7 The legislation will need to include accurate and certain definitions to ensure that the intended population of companies benefit and it is not open to abuse. In addition it may also be desirable for the legislation to include conditions, for example requiring continuity of activities or ownerships before and after the disincorporation.

6.8 The legislation needs to ensure it gives taxpayers certainty. It needs to be equitable and proportionate.

[44] The final report of the OTS review of tax reliefs can be found at: http://hm-treasury.gov.uk/ots_taxreliefsreview.htm
[45] http://www.hm-treasury.gov.uk/d/tax_policy_making_response.pdf

Anti-avoidance

6.9 Anti-avoidance provisions will need to be considered to prevent unintended behaviours. The wider the relief, the greater protection required and the example at Annex B illustrates the scale of the relief.

6.10 The key issues here are to prevent companies from "vanishing", thus prejudicing the interests of creditors, minority shareholders and the Exchequer. Any practice of asset stripping or "phoenix" companies that allow the same shareholder(s) to incorporate and disincorporate serially, taking advantage of tax neutral or tax favoured status each time, needs to be guarded against. However, the transactions in securities anti-avoidance legislation[46] already in place does provide some protection.

6.11 There may need to be specific anti-avoidance provisions to target disincorporations for non commercial purposes, where accumulated cash (after salary and dividend extraction), or capital assets normally liable as chargeable gains at either company or shareholder level, would otherwise be extracted with no immediate tax liability.

6.12 Provisions would also be necessary to ensure consistency of Entrepreneurs Relief for the successor business holder, to ensure this was in line with any relief that would have been available to the shareholders.

State aid

6.13 If the relief is targeted at a specific size of company, it may constitute EU State aid, as it would be a relief targeted at companies of a specified size. State aid is a concept designed to protect the free market by ensuring that a Member State does not give assistance to specific "undertakings" that would distort competition or put those undertakings at an unfair advantage. "Undertakings" are entities engaged in economic activity, for example entities in specific industry sectors, categories of companies according to size. State aid is prima facie illegal, but in certain circumstances the European Commission may give approval for measures that qualify as State aid. If the disincorporation relief is taken forward, this issue needs to be explored properly.

Revenue implications

6.14 The remit for this OTS's review of small business taxation is to be broadly cost neutral. In order to be able to make robust proposals in this area, we will need to carry out further analysis into the implications for tax revenue, including the impact of potential evasion and avoidance.

Questions for consultation:

13. Do you have any comments on the balance of simplification (of business structures) against the added complexity of further legislation?
14. Could a disincorporation relief be written simply – perhaps just the 'narrow' option in the previous chapter?

[46] ITA 2007 Part 13, Ch 1

7 Questions for consideration

Questions for consultation:

Why introduce a disincorporation relief?

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

Current tax implications of disincorporation

4. 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?
5. Are there any significant further tax or general issues on disincorporation other than those listed in Chapter 3 that need to be considered?

Which companies may benefit from a disincorporation relief?

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

What might a disincorporation relief look like?

9. 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?
10. 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?
11. Is there evidence that any of the further tax issues listed, outside the narrow and wider options for relief, are preventing companies from disincorporating?
12. Would the 'wider' relief be open to abuse? If so, how? Would a bona fide commercial test be sufficient to protect the revenue? Would the protection need to go further, such as the chargeable payments rules in the demerger relief?

Would a disincorporation relief be a simplification?

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

8 Next steps

How to respond

8.1 The OTS welcomes answers to the questions listed in Chapter 7 and any wider comments on the proposals in this discussion paper. At this stage the key question is the potential demand for the relief; respondents are encouraged to comment on this issue even if they do not have time to comment on some or all of the consultation questions.

8.2 Responses should be sent by e-mail to OTS-SmallBusiness@ots.gsi.gov.uk, or by post to:

Anish Mehta

Review of small business tax

Office of Tax Simplification

1 Horse Guards Road

London

SW1A 2HQ

8.3 Comments should be received by Friday 7 October 2011.

Confidentiality disclosure

8.4 Information provided in response to this discussion document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

8.5 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding the OTS.

8.6 The OTS will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A Summary of tax consequences on disincorporation

A.1 The tax consequences for the company and for shareholders are set out below. For further reading, a number of journal articles cover the subject[47].

Tax consequences for the company

A.2 There is a deemed cessation of trade for corporation tax purposes; so the accounting period terminates, which may accelerate the date for paying corporation tax; for example a company with an accounting year ended 31 December 2011 would normally pay corporation tax by 1 October 2012, however a disincorporation on 31 October would accelerate the last payment date to 1 August 2012.

A.3 A trading loss may be set against other profits or chargeable gains of the company, in the current accounting period or the preceding accounting period. For example a company with a trading loss of £10,000 in the accounting year ended 31 March 2011, with no other income or chargeable gains, but with trading profits of £5,000 in the preceding year, may set the loss against the earlier year's profits. The balance of trading loss £5,000 may then be carried forward against subsequent trading profits. However, following disincorporation, the unused trading loss may go back against total profits of the final three years, but may not be carried forward into the disincorporated business.

A.4 A capital loss may normally be set against chargeable gains of the current and subsequent accounting periods, but may not be set against gains arising on the shareholders on disincorporation, nor subsequent capital gains of the unincorporated business. Existing capital losses may be used to absorb gains on disincorporation.

A.5 As the company and the subsequent owner(s) of the disincorporated business will almost certainly be connected, closing stock and work in progress will be deemed to be sold at market value by the company[48]. However there is the possibility for both parties to elect[49] for closing stock to be transferred at actual transfer value (as long as this is not less than book value) resulting in a tax neutral transfer.

A.6 Chargeable gains will arise on the transfer of chargeable assets (mainly property) to the successor to the business, and the assets are deemed to have been disposed of at market value[50].

A.7 Where a trade was carried on prior to 1 April 2002 (when the intangibles regime was introduced), a significant chargeable gain may arise on the transfer of goodwill, as it is likely that the value will have increased over time. Agreeing the valuation of this with HMRC could be a lengthy process.

47 See for example "Get back ... to where you once belonged!" Peter Rayney, Taxation 28 June 2007

48 CTA 2009 s165

49 CTA2009 s167(1)-(4) previously ICTA 1988 s100(1C)

50 TCGA 1992 s17

A.8 For a trade started after 31 March 2002, any goodwill will be treated under the intangibles rules[51], and on the disposal of post 2002 goodwill any gain is treated as a trading credit, taxable as trading income. Again, agreeing the valuation of this with HMRC could be a lengthy process.

A.9 Intangible assets other than goodwill will also give rise to a tax charge on transfer to a sole trader, and would have to be valued.

A.10 For plant and machinery, no capital allowances will be given in the final period, but a balancing allowance or charge will arise based on the actual transfer value of the assets. There is the option for a joint election between the parties to be made for the assets to be transferred at tax written down value[52] ensuring a tax neutral transfer.

A.11 If the business owns property, e.g. trading premises, in addition to a potential chargeable gain, there will be a charge to stamp duty land tax on the transfer. This can be avoided in the course of a winding up, by distributing the property in specie to the shareholder, thus avoiding SDLT, and ensuring treatment as a capital distribution in the shareholder's hands.

A.12 If the business is VAT registered, the general rule is that on the cessation of a trade, the registered person is deemed to make a taxable supply of the goods held by the business. However, if the successor to the business was previously a shareholder, the transfer of going concern provisions[53] will apply and no VAT will be levied on the transfer. It is also possible for both parties to elect for the business's existing VAT registration to be carried over to the successor to the business.

Tax consequences for the shareholders

A.13 A distribution of assets to the shareholders by a company is an income distribution by virtue of section 1020, CTA 2010. If HMRC applies ESC C16 (or the future legislative equivalent), the distribution will be treated as capital in the hands of the shareholder (subject to assurances from the company that include that the company does not intend to trade in the future, applies for striking off, collects debts and pays off creditors.

A.14 Shareholders will then be charged to tax on capital gains, based on the excess of distributions received over the base cost of the shareholdings. This will effectively impose a double tax charge, as both the company and the shareholder will suffer a tax charge based on the appreciation in value of the company's chargeable assets.

A.15 A benefit in kind charge may arise where assets are passed to the shareholders for no consideration, and the shareholders are also directors or higher paid employees.

A.16 Directors (and employees) may receive termination payments, specifically to compensate for giving up their employment rights. Depending on the circumstances surrounding such payments (e.g. whether or not they are contractual) they may be exempt to the extent that they do not exceed £30,000[54].

A.17 A worked example of the tax charges arising on the company and the shareholder, and the relief available under option 2 (wider relief) is set out in Annex B below.

[51] CTA 2009 Part 8

[52] CAA 2001 ss266 - 267

[53] VAT (Special provisions) Order 1995, Art 5

[54] ITEPA 2003 ss 401 - 405

B Disincorporation case study

KENNY'S TOURS LTD

Kenny has run his Heritage Coast Tours business as a single shareholder through a limited company since July 2001, and draws up his accounts to 30 June each year. He is finding the administration of his own payroll too time consuming and does not wish to incur further accountancy fees, so chooses to disincorporate from 30 June 2011.

The balance sheet shows the following values

	Book value (£)	Market value (£)
Freehold office/shop	100,000 (cost)	250,000
Goodwill	-	50,000
Fittings, plant, coach	15,000	20,000
Stock items (transfer value)	1,000	
Cash	24,000	
Debtors	2,000	
Creditors	(3,000)	
	139,000	

For the year ended 30 June 2011, the tax adjusted trading profit is £35,000, with bank interest of £200. The tax written down value of plant etc is £18,000 (election made to transfer at tax written down value).

Corporation tax due for year ended 30 June 2011:

			£		
Tax adjusted trading profit			35,000		
Interest			200		
Chargeable gains	*Goodwill MV*		50,000		
	Property MV	250,000			
	Cost	(100,000)			
	Indexation, say	(40,000)	110,000		
Profits chargeable			195,200	*3/12 @ 20% =	9,760
				*9/12 @ 21% =	30,744
Corporation tax due					£40,504

A capital distribution arises on the shareholder, giving rise to CGT on Kenny as follows

			£	
Net reserves (above)			139,000	
Goodwill surplus			50,000	
Property surplus (distributed in specie will avoid SDLT)			150,000	
			339,000	
Less:	Corporation tax	40,504		
	Liquidators fee (say)*	10,000	(50,504)	
Distribution representing capital gain			288,496	
Less: Annual exemption			(10,600)	
CGT for 2011-12[55]			277,896	@10% = **£27,790**

* Treatment utilising current ESC C16 provisions would remove the need for a liquidator's fee.

Chargeable gains reliefs under the wider option 2 would hold-over the chargeable gain on the company of £160,000 (saving at the point of disincorporation £160,000 x 3/12 @ 20%, x 9/12 @ 21% =£33,200), and defer the capital gain on Kenny of £288,496 (saving at the point of disincorporation £27,790), total saving at this point £60,990.

[55] With entrepreneur's relief, and assuming no other gains or losses in the year.

C Striking off and members' voluntary liquidations

C.1 Whilst there are circumstances in which it may be desirable to retain the dormant shell company (for example, to preserve the company name), there are administrative burdens associated with dormant companies, such as the requirement to submit an abbreviated balance sheet and notes to Companies House. Where there is no need to preserve the dormant company, there are a number of ways in which a company can cease to exist, but the most appropriate and cost effective are:

- striking off[56]; and
- members' voluntary liquidation[57].

Striking off

C.2 Striking off is the simplest and most cost efficient method; however it is only available where, at any time in the last 3 months the company has not, inter alia, traded or carried on in business[58]. Thus the trade and assets of a company would have to be transferred to its shareholder(s) at least 3 months before an application for striking off is made. This method is administratively simple, involves few legal formalities and minimal cost. However, share capital, and non distributable reserves cannot be distributed, but this is unlikely to be a problem as most companies looking to be struck off would typically have very small share capital. Under Extra Statutory Concession ("ESC") C16, HMRC will usually treat a distribution to shareholders prior to dissolution, as having been made under a formal winding up, subject to certain assurances being made by the directors, i.e. it will be treated as a capital distribution in the hands of the shareholders. It is unlikely that, where a striking off is for a redundant company, HMRC will not agree to the application of ESC C16. The Government are consulting on incorporating ESC C16 into legislation[59].

Members' voluntary liquidation

C.3 If the simple and economic dissolution is not possible, the shareholders can pass a special resolution to place the company into members' voluntary liquidation. This is an option available to solvent companies only, as the directors must give a statutory declaration of the company's solvency and must also declare that the company can pay its debts within twelve months of the commencement of the winding up. A liquidator is appointed whose responsibility it is to wind up the company, transfer the business and assets to the new unincorporated business, pay off the creditors and distribute the surplus to the shareholders. There are costs and legal formalities associated with this option.

[56] Companies Act 2006 ss 1003 - 1011
[57] Insolvency Act 1986 ss 91 - 96
[58] CA 2006 S1004
[59] "Extra Statutory Concessions – the 4th Technical Consultation on Draft Legislation", HMRC, 13 December 2010

Office of Tax Simplification contacts

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

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ISBN 978-1-84532-887-0