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Sole Enterprise with Protected Assets

A discussion paper

1. Introduction

The OTS found during the Small Company Taxation (SCT) review¹ that many of the smallest companies struggled with the tax compliance burdens associated with being a company. At the same time we noted that, as reported in Ipsos MORI's prior research², the most common reason given by small companies for incorporation was for limited liability rather than tax reasons.³

Following the OTS's report, the Financial Secretary to the Treasury endorsed our recommendation that the OTS further explore a Sole Enterprise with Protected Assets (SEPA)⁴ model, which would make provision for protecting one or more of the assets of a self-employed individual.

SEPA would be a way of providing a degree of personal asset protection to business owners, potentially eliminating the need to incorporate solely for limited liability. The key would be that the SEPA user's home would be protected against claims arising from the business.⁵ The premise is that this would be a simplification for businesses that choose to use SEPA and remain in the simpler self-employed tax and regulatory regime, as compared with incorporating. As well as potentially offering a simpler route for carrying on business, there is a secondary consideration of whether the availability of such a route would encourage entrepreneurship.

However, we are well aware that SEPA may not be an appropriate alternative to incorporation for those individuals who work either through an agency or direct with large private or public sector organisations where the engager requires the contractor to have a separate legal identity. The self-employed individual using a SEPA would not have a separate legal identity.⁶

2. Objectives of this paper

The intention is for this paper to be used as a basis for an open discussion, directly or through submissions, with the business community and all other interested parties. We want to stimulate debate on

- Whether there are any further areas to explore in relation to SEPA; and
- Whether or not SEPA is something that is likely to have take up.

¹ <https://www.gov.uk/government/publications/small-company-taxation-review>

² HMRC Research Report 317 - Reasons behind incorporation

³ Though tax reasons were an important factor, of course.

⁴ The concept can also be referred to as Self Employed with Protected Assets; as the paper discusses, it may be that 'Asset' in the terminology should be singular rather than plural. As will be appreciated, 'SEPA' encompasses all these permutations.

⁵ The extent of this protection and interaction with possible claims arising other than through the business are explored later.

⁶ There are other models such as the Self-Employed Business and Freelancer Limited Company that attempt to address this issue. These were discussed in the SCT review and are issues that the OTS may return to elsewhere.

This paper develops our thinking on what we believe a SEPA model could look like. It is not a complete model and there are plenty of issues to be resolved. However, our aim in publishing a short paper at this stage is to encourage a wide debate on SEPA. To that end we include a number of specific questions and we would be grateful for any views/comments from interested parties.

We are continuing to work on SEPA development and, while doing so, are asking the following strategic questions:

- Would the new status be easily understood – or would it cause confusion?
- Would traders want to use it as an alternative to incorporation?
- Would traders that were never considering incorporation use it?
- Would it be accepted as a valid business form by other traders and, crucially, banks and other potential creditors?
- Would the mooted legal protection against personal assets work in practice under the law of insolvency and other areas?
- Would it result in a simpler route for carrying on business? And
- In many ways beyond our remit of tax simplification but a key ‘wider issue’ question – what type of behaviour could this encourage by removing worries about losing personal assets? E.g. greater entrepreneurship, growth or innovation?

We plan to publish our conclusions on SEPA in October. As always with OTS projects, we welcome comments at any time but would prefer responses to this paper by 12 September if possible, though our absolute deadline is 30 September. Please send comments to: ots-smallcompanies@ots.gsi.gov.uk.

In the meantime we will be continuing our research on SEPA so if you would be interested in meeting us to discuss the subject further, please do let us know.

3. Why SEPA?

There are 3.3m self-employed sole proprietors in the UK, of which 274,000 are employers⁷; all of these individuals trade with unlimited liability⁸. There are some 723,000 non-employing limited companies⁹. All of these represent the potential target population for SEPA, together with some small companies with one or two employees. We expect that a number of the simplest existing companies would, with appropriate disincorporation relief, also prefer to be a SEPA business than a company.

There is also anecdotal evidence to support that offering some form of personal asset protection encourages enterprise.

Providing the self-employed with the SEPA model for protecting their main assets, therefore, was considered a viable option and a potential simplification by the OTS. The potential simplifications are:

- No need to form a limited company to gain asset protection; consequently
- Ability to continue to use cash accounting as a sole trader, rather than GAAP accounts; and
- Not having to deal with complications that arise from corporation tax.

⁷ BIS Business Population Estimate 2015

⁸ Many such unlimited businesses will carry insurance – usually termed professional indemnity insurance – to guard against claims but such insurance will never offer complete cover against ‘catastrophe’ claims.

⁹ Ibid; the Limited Liability Partnership (LLP) structure is also relevant and is available to small enterprises. As it requires two or more members, it is not for sole traders though the OTS report did note how this is being managed by some with the use of a dormant company.

In addition to the simplification benefits, SEPA owners also retain the financial protections¹⁰ offered to sole traders.

In order to keep SEPA as operationally simple as possible it would have the same tax and accounting treatment as sole traders, i.e. the same access to cash accounting and same income tax/NICs treatment.¹¹

Asset protection

The core principle of SEPA status is that it would provide protection for some or all of the owner's private (i.e. non-business) assets against claims arising from the business. The assets covered by SEPA would in effect be in a protective ring-fence. This protection could be framed to cover:

- The owner's interest in their primary residence only; or
- A wider class of assets.

Our working assumption is that the protection would be only for the primary residence. We considered expanding protection to other key assets but concluded that it was the fear of losing one's home that often drove people to wanting protection. Additionally, and importantly, framing the rules in terms of limiting the protection to just one asset, and that asset being relatively illiquid, keeps the model simple and minimises the risk of abuse of the system. Furthermore, we believe the Taking Control of Goods Regulations 2013 provide adequate protection for tools of the trade and life essentials.

The protection would be against claims and losses arising from the SEPA business. Offering protection for *all* disputes would be possible but it would take SEPA into totally different territory. We would essentially be opening up the possibility that every citizen (assuming everyone would want to take it up) has their primary residence protected from any debt owed to anyone. That seems well beyond the policy objective that we are trying to achieve.

Employment Status

SEPA status would not affect employment status considerations for the user and the same employment law considerations would arise as now. It would not, therefore, preclude a SEPA user being classified as an employee (for tax and/or employment rights purposes) of a hiring organisation. So the SEPA model should not give rise to any additional employment status issues.

Insolvency

Allowing sole traders to benefit from some sort of asset protection would shift the balance of risk. In business to business transactions it can be seen as a zero sum game, i.e. a trader may be at greater risk if they are a creditor to a trader with SEPA status, but they in turn could have a greater protection from their creditors.

There is a more genuine risk shift in business to consumer interactions. Customers seeking redress would no longer be able to place a charging order on a house under the Charging Order Act 1986 unless the trader was found criminally negligent. We are working with the Insolvency Agency and the Land Registry Office to try to quantify any potential impact that SEPA would have here, but we would very much like to hear from anyone involved in this area.

¹⁰ Companies lose the right to access the Financial Ombudsman Service. Sole traders are also treated as consumers when taking loans of less than £25,000 and can take financial services companies to court if they are in breach of FCA rules.

¹¹ In saying this, we are well aware of the merits of full accruals accounting to give a proper picture of the results of a complex business. But for a simple business – the sort carried on by the great majority of sole traders/proprietors – cash basis will suffice and accruals basis only adds complexity and (probably) cost. It would always remain open for the business to opt for full accruals accounting of course.

There is also a related question of whether traders with SEPA status might find it harder to engage with customers. We think this is unlikely to be the case—after all, we are yet to come across a case of a consumer asking if a trader was a home owner before making a purchase.

Q1. Do you agree with this broad outline of the SEPA model? In particular do you agree with protection being only in terms of business debt? If not, what would be the most practical approach?

Q2. Do you agree that only the primary residence should be protected?

Q3. We have not proposed that we cap the value of the protected primary residence. Do you think this would be necessary to prevent risk of abuse? If so what would be a suitable cap?

4. Becoming a SEPA

Entry criteria

All individuals with the right to work in the United Kingdom and with national insurance numbers would be able to apply for SEPA status.

However, there would be a need to have some modest restrictions around the entitlement to SEPA status. The starting point would be to broadly mirror restrictions on becoming a director. So it could be that individuals who are currently under an IVA (individual voluntary arrangement), bankrupt, disqualified from holding directorships, insolvent, or serving bankruptcy restriction orders or debt relief restriction orders would not be able register for SEPA status.

Any individual charged with bankruptcy, disqualified from holding directorships, declared insolvent, or served with bankruptcy restriction orders or debt relief restriction orders would lose their SEPA status for all future business ventures until the relevant restrictions have lapsed.

Q4. Are these qualifications and restrictions reasonable? Or would they damage someone's ability to get back into business after having problems? Are there any other individuals who should or should not be allowed to apply for SEPA status?

Registration process

SEPA would need a registration procedure. This would be needed to generate some form of register of SEPA businesses for consumer protection purposes. Although it would impose some administrative burden on the SEPA user beyond that shouldered by a sole trader, it seems a reasonable requirement, provided the process is kept simple and 'light touch'.

We envisage the SEPA registration taking only a few minutes and require a minimum amount of information, including:

- Full name;
- Date of birth;
- National insurance number;
- Contact details (correspondence address, telephone number and email address);
- Trading name(s);
- The relevant Standard Industrial Classification (SIC) code(s); and
- A declaration of solvency.

For businesses registered with HMRC, Government will already hold most of this information so this shouldn't have to be resubmitted. The output would be a single unique SEPA number to cover their

activities; aspects of the registration information (probably owner's name, trading name and SEPA number) would be publicly available.

Q5. Is there any other information that should be required for SEPA registration?

5. Some wider SEPA formalities and procedures

The legal environment requirements for SEPA would be as for sole traders. In considering the design of SEPA we have considered a wide range of issues as noted below:

- An individual would not have to inform existing clients that they intended to become a SEPA (in line with no duty to inform on incorporation), but...
- Once trading as a SEPA, all correspondence, promotional materials etc. would have to state that the business is a SEPA and quote the registered number.
- Individuals may well have more than one line of business. We have considered whether they should be able to form more than one SEPA but our inclination is that, to keep it simple, people can have multiple businesses covered by SEPA but they will only be given one unique SEPA number. Thus SEPA business owners will have to register any business for which they wish to have SEPA status. In doing so they will have to provide their full name, national insurance number, correspondence address and the names and sectors of any businesses that they wish to be covered by their SEPA status.
- SEPA status is for individuals. Two or more people cannot jointly share a SEPA status but multiple individuals with their own SEPA statuses can be involved in a joint enterprise just as multiple sole-traders are able to do.
- As SEPA status attaches to the sole trader personally, it is not something that can be passed on to heirs or sold. Clearly the business could be passed on or sold but the new owner would then have to register afresh as a SEPA.
- SEPA would not protect against losses incurred in relation to contracts agreed before registration.
- There would be no requirement for a separate business bank account, or public trading records that are often associated with more formal business structures.¹²
- If a sole trader has incorporated and wants to move their business to the SEPA model, they may be able to take advantage of the disincorporation relief. In order to have any significant impact we repeat our earlier recommendation that disincorporation relief is amended as per our original recommendations, rather than the restricted version that has been introduced.¹³ As of March 2016, less than 50 companies had made use of the relief.¹⁴
- Creditors may still be entitled to ask for any business loan to be secured against a residence (i.e. a re-mortgage), which often occurs with small businesses. In this instance the conditions of the re-mortgage would still hold, regardless of the SEPA status.

¹² However, a separate business bank account would be recommended, as it is for sole traders.

¹³ OTS Small Company Taxation Review, March 2016

¹⁴ HMRC data

- As with a director of a limited company, the sole trader would still be liable personally if they are found guilty of fraud or other serious failures in their business responsibilities.
- Users will be able to log on and add/remove business activities or end their SEPA membership at any time using a Government Gateway username and password.

Q6. Are there any other formalities and procedures that would have to be considered?

6. Evaluating SEPA

Whilst we acknowledge the benefits of SEPA, we are also aware that there are risks. We intend, through direct engagement with the wider community, to evaluate these risks against the potential benefits of SEPA. The key risks we have identified which we will need to show how they can be managed in any final proposal are:

- The potential for confusion within the micro-business sector through introducing a different business vehicle;
- The impact for creditors who would have fewer assets against which to make a claim; would this make them less willing to engage in business with a SEPA;
- The potential to distort the housing market, although initial assessments show any risk to be negligible;
- Whether the risks that SEPA protects against could equally well be met by developing suitable insurance policies, which would perhaps be simpler than developing a new business structure;
- The potential impact on the availability of credit. Lenders may be less willing to lend to sole traders if they know that their house is protected. However, this may also improve the availability of secured credit, including mortgage, if the lender knows that the property is not at risk in a trade dispute;
- Risk of abuse from “phoenixing”¹⁵ behaviour or using SEPA to protect against other losses, e.g. gambling debts, possibly through ‘managing’ cash flows to pay off mortgage debt rather than trade debt and so end up with a full-protected house whilst leaving ordinary creditors exposed; and
- Having sufficient uptake from the target audience so that the simplification outweighs the complexity of adding another business model.

Q7. Are there any other negative impacts that we need to consider?

Finally, although it is perhaps beyond the strict remit of the OTS, we want to raise the wider question of whether SEPA will boost enterprise through simplifying procedures and removing concerns from those considering going into business.

Q8. What is your evaluation of the SEPA concept? Will it be a useful addition to the UK business landscape and encourage enterprise?

¹⁵ Phoenixing refers to the practice of dissolving a company to not have to pay its debts then creating a new company to continue the same trade.