Office of Tax Simplification

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Disincorporation relief – what of the future?

Introduction

Disincorporation relief was introduced in Budget 2013[1] following extensive work by the OTS.[2] The relief applies to business transfers within the period of 5 years beginning on 1 April 2013 and ending on the 'sunset date' of 31 March 2018.

The OTS recognises that 'sunset' provisions of this kind can be a useful way of ensuring that the ongoing need for a provision is subject to periodic review. It is then important that such a review takes place.[3]

We are publishing this focus paper to draw attention to the potential for this relief to fall by the wayside unless action is taken, and to stimulate debate about whether it is achieving its purpose.

Background

The government's response[4] to the consultation it ran following the OTS's work recognised that

> "some small businesses who have opted to become a limited company in the past may now feel 'trapped' in a more onerous tax regime for companies and could benefit from moving to a simpler legal form."

Disincorporation relief was intended to help address this, to remove some of the potential tax barriers to a business changing its legal status from that of a limited company and to enable those conducting the business to become, or revert to being, self-employed or in partnership.

The potential simplification benefit, for those businesses that find the additional burdens of running a company outweigh the advantages of incorporation, is to enable them to change their legal status more easily thereby reducing their administrative burdens.

[1] See section 58 FA 2013, the Budget 2013 costing note https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221895/budget2013_policy_costings.pdf, and the more detailed HMRC note published with the draft legislation on 11 December 2012: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/179240/disincorporation_relief.pdf.pdf

[2] See in particular a report the OTS published in February 2012 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/199181/03_ots_small_business_tax_review_disincorporation_280212.pdf

[3] See paragraphs 1.62 to 1.65 of the OTS small company taxation review https://www.gov.uk/government/publications/small-company-taxation-review

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/190258/consult_govt_response_disincorporation_relief_111212.pdf

The OTS's work in 2016, on a potential new registered status for self-employed people, which we dubbed 'Sole Enterprise with Protected Asset' (SEPA),[5] was also motivated by such considerations.

More widely, the OTS notes that facilitating disincorporation would appear to fit well with any moves to reduce the extent of tax motivated incorporations.

Scope of the relief

On a disincorporation, there are potentially two tax charges:

- First, corporation tax on the company in relation to
    - chargeable gains on the market value of its chargeable assets, essentially pre-2002 goodwill and land/buildings, and
    - any gains on post-2002 goodwill, which are taxed as income.
- Second, personal tax (normally capital gains tax[6]) on the shareholders when the company's assets are distributed to them on liquidation.

The disincorporation relief in FA 2013 allows transfers of interests in land and goodwill to be made at cost or written down value (unless the market value is lower), so that no gain is chargeable on the company.[7] However, the tax charges on the shareholders are unrelieved.

The relief is limited to businesses with qualifying assets (goodwill or interests in land) valued at less than £100,000 at the time of the transfer.

Take-up of the relief

The HM Treasury consultation response[8] noted that around 610,000 companies (approximately 40% of UK companies) would be eligible to access the relief.

However, as of March 2016 fewer than 50 claims had been made.[9] There are a number of possible reasons for this, including the following:

- few businesses actually wish to disincorporate
- there may be insufficient awareness of the relief
- it is too much trouble, or too costly in terms of adviser fees or for other reasons, for businesses to take this step, even if there would be ongoing benefits from doing so
- the relief is too limited, either because
    - the £100,000 limit is too low, or
    - the charge on the shareholder is not also relieved.

OTS impressions and observations

The OTS has taken some soundings with advisers and offers the following observations to help stimulate debate about the position.

[5] https://www.gov.uk/government/publications/ots-final-report-on-sole-enterprise-with-protected-assets-sepa
[6] However, an income tax charge applies instead where the company applies for striking off the company register and total distributions in anticipation of the winding are £25,000 or more, section 1030A CTA 2010.
[7] Sections 162A and 162B TCGA 1992; section 849A CTA 2009
[8] https://www.gov.uk/government/consultations/disincorporation-relief
[9] Paragraph 6.53 of the OTS small company taxation review https://www.gov.uk/government/publications/small-company-taxation-review

We continue to hear anecdotally that there is still an appetite for small companies to disincorporate, especially if the relief were to more fully mirror the reliefs on incorporation.[10]

This would fit with the suggestion that tax charges on a business should in principle be the same, so far as possible, whatever its legal form; and that as a business grows or contracts, or the circumstances of those running it change, tax should not be a barrier to flexibility in changing its legal form.

This though begs the question why the relief is not presently being used to any significant extent.

We continue to hear of a lack of awareness among advisers and businesses of the relief, and given the limited take-up, it is clear there will be limited experience of it in practice. This may in turn mean the administrative or advisory costs of taking advantage of it are not commensurate with the benefits of making the change or the amount of relief involved.

It has been suggested to us that the relief is indeed too limited at present, and to be effective either both tax charges should be deferred, or one should be eliminated. Specifically, we have been told that the £100,000 limit is quite often an early knock-down barrier to consideration of the relief, particularly where non-purchased goodwill is involved.

We appreciate that the limit was intended to help keep the relief simple and reduce the need for anti-avoidance legislation, but note that the new targeted anti-avoidance rule on company distributions on a winding up in FA 2016[11] to counter phoenixism now offers additional protection. Clarification would be welcomed that a straightforward disincorporation would not fall within this provision.

In addition, as regards potential flip-flopping between business forms in order to utilise amortisation of post-2002 goodwill, this is now combatted by the provisions introduced by section 25 FA 2015.

Which types of company may wish to disincorporate?

The research carried out jointly for the OTS and HMRC in 2011 showed that 14% of the companies surveyed would like to disincorporate, in particular those with a turnover between £20k and £30k.

Understanding the types of company or business that may wish to claim would be useful evidence for the government to take into account when deciding whether the relief should remain or potentially improved.

The OTS understand this population is likely to consist mainly of small one-person or family companies, which

- were not formed in order to obtain, or do not need, limited liability, and
- do not, or no longer, need to be incorporated to satisfy criteria applied by suppliers on certain contracts.[12]

[10] Hold-over relief is available under s162 TCGA1992 to a business (as clarified in Ramsay v HMRC [2013] UKUT0226) on aggregated gains on chargeable assets, set against the value of the shares

[11] Section 396B ITTOIA 2005

[12] See Chart 1A in, and paras 2.15-2.18 of, the OTS small company taxation review https://www.gov.uk/government/publications/small-company-taxation-review

If a new trading vehicle offering liability protection while retaining the simplicity of self-employment (SEPA, referred to above) were introduced, existing companies wishing to change to the new status would also need access to a disincorporation relief.

Recent changes to dividend taxation on shareholders reduce the tax advantages from incorporation in cases where all profits are withdrawn. The proposed reduction in the dividend allowance from £5,000 to £2,000 which is to be reintroduced in a Finance Bill after the summer recess, is intended to take effect from April 2018, just as disincorporation relief is due to expire.

From this date there may be more small companies finding that the additional administration burden outweighs the tax advantages: we calculate the maximum additional post-tax profit from a limited company, compared to self-employment is currently £2,802, at a profit level of £60,000.[13]

This reduces as profits reduce (to just £766 at profits of £25,000) and, interestingly, also reduces as profits exceed £60,000. The additional maximum post-tax profit via the limited company will be reduced by a further £373 (to £393 at profits of £25,000) once the planned abolition of class 2 national insurance and the reduction of the dividend allowance to £2,000 are taken into account.

Regarding the additional admin burden of operating through a company, research was carried out in a 2015 Ipsos Mori HMRC research report into understanding tax administration for businesses, which reported that surveyed micro companies paid an average agent's fee of £1,853, while the average agent's fee across all businesses for the self-employment return was £426.[14]

- Does the difference form a reasonable representation of the additional admin burdens involved?
- Given that policy makers need to understand the balance between costs to business and advantages derived, what other factors apply when looking at the tipping point for disincorporation, and can these be quantified?

Conclusion

We are publishing this paper to draw attention to the fact that the default position, if no action is taken, is that disincorporation relief will cease to apply from 1 April 2018, and to stimulate debate.

If there is an untapped appetite for businesses to disincorporate to reduce administrative burdens, or views about the minimum improvements that would be needed for the relief to be effective, the OTS would be interested to hear from you. This can be by email to ots@ots.gsi.gov.uk at any time, but given that the relief is due to expire on 31 March 2018, we ask that you do so by 15 September if possible.

The Office of Tax Simplification

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[13] These differences are referred to in the Office for Budget Responsibility fiscal risks report July 2017: http://cdn.budgetresponsibility.org.uk/July_2017_Fiscal_risks.pdf

[14] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/443746/HMRC_Report_375_Tax_Administration.pdf