

Evaluation update and stock take  
of OTS work on corporation tax,  
personal service companies and  
self-employed people's taxation



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# Executive summary

The Office of Tax Simplification (OTS) is the independent adviser to government on simplifying the UK tax system. The work of the OTS is rooted in improving the experience of all who interact with tax. The OTS aims to improve the administrative process – which people encounter in practice – as well as simplifying the rules. These are often of equal importance to taxpayers and HMRC.

The 2018-19 OTS annual report<sup>1</sup> noted that the impact of the Office’s work ‘is felt in a variety of ways, both through formal responses to our work, action taken on our recommendations, an enhanced (we hope) quality of informed public debate and a more pervading influence in government.’

This note seeks to enhance debate and inform policy thinking in two ways.

First, it provides an evaluation update on the OTS’s June 2017 report on the *Simplification of the corporation tax computation* and the ensuing *Accounting depreciation or capital allowances?* report in June 2018.

This reflects the commitment made in the OTS 2018-19 annual report to ‘review the impact of our more significant recent reports’, following on from the October 2019 evaluation update<sup>2</sup> on the OTS’s November 2017 report *Value added tax: routes to simplification*<sup>3</sup>.

Secondly, this note goes on to bring together a stock take of the OTS’s wider work relating to small companies, including personal service companies, the individuals, freelancers or contractors who provide their services to engagers through them, tax reporting and payment arrangements for self-employed people, the boundary between employment and self-employment and related differences in the incidence of income tax and National Insurance Contributions.

The OTS hopes that this note will be a useful contribution to current thinking, noting

- the Chancellor’s statement in conjunction with the 26 March 2020 announcement<sup>4</sup> of the Covid-19 support package for self-employed people:

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<sup>1</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/817692/OTS\\_Annual\\_Report\\_2018-19\\_-\\_web\\_copy.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/817692/OTS_Annual_Report_2018-19_-_web_copy.pdf)

<sup>2</sup> <https://www.gov.uk/government/publications/ots-publishes-an-evaluation-update-on-its-vat-report>

<sup>3</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/657213/Value\\_added\\_tax\\_routes\\_to\\_simplification\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/657213/Value_added_tax_routes_to_simplification_web.pdf)

<sup>4</sup> <https://www.gov.uk/government/speeches/chancellor-outlines-new-coronavirus-support-measures-for-the-self-employed>

*“It is now much harder to justify the inconsistent contributions between people of different employment statuses. If we all want to benefit equally from state support, we must all pay in equally in future.”*

- that the lack of information available to HMRC about the amount and nature of company dividends through the present tax administration arrangements for those who work through personal service companies has meant the government has not been able to find a way of providing them with Covid-19-related support (as noted in the Treasury Select Committee’s report of 15 June 2020)<sup>5</sup>

Among the various observations and developments highlighted in this note, the following stand out:

*Simpler tax for smaller companies:* HMRC is continuing to consider the recommendation to explore following the accounts more closely, at least for smaller companies, with only a minimum number of tax adjustments being required. The OTS looks forward to seeing where this leads and to continue contributing to any future work in this area.

*Personal service companies:* The OTS suggests renewed consideration of enabling a small personal service style business to operate through a UK limited company while being treated as transparent for tax. The aim would be to provide a fully recognisable form of limited liability, removing the business from corporation tax (salaries, dividends and loans to participators being ignored for tax purposes), together with the relative ease of a self-employment style tax calculation.

*Tax Administration:* The OTS reiterates the merit in HMRC doing more to enhance the personal tax account and to integrate it with the business tax account, to provide an end-to-end tax reporting and payment service and facilitate the simplification of tax administration for self-employed people.

*Employment and self-employment:* The OTS is interested in the possibility of a statutory definition of employment for tax purposes being developed. This need not be an attempt simply to codify the current case law principles but could have different features.

The OTS is grateful for discussions with a range of stakeholders, including HMRC and HM Treasury, since the original reports were published, which have helped to inform this note, and will maintain an ongoing dialogue with them and stakeholders about the ideas and suggestions highlighted here.

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<sup>5</sup> <https://committees.parliament.uk/publications/1446/documents/13238/default/>

# Chapter 1

## Corporation tax computation and Accounting depreciation reviews

- 1.1 The terms of reference for the OTS's corporation tax review were published in May 2016.<sup>1</sup> The report was published in June 2017<sup>2</sup> and contained 7 main and 25 additional recommendations.
- 1.2 The Chancellor responded on 14 August 2017<sup>3</sup> and asked the OTS to carry out further work on accounting depreciation and capital allowances.
- 1.3 The scoping document for the OTS's ensuing review on accounting depreciation and capital allowances was published in September 2017.<sup>4</sup>
- 1.4 The report was published in June 2018<sup>5</sup> and the Chancellor responded on 20 December 2018,<sup>6</sup> following Budget 2018.
- 1.5 The recommendations in these reports were framed around four areas:
  - simplifying tax relief for capital investment
  - aligning the tax rules more closely with the accounting rules generally
  - issues affecting the largest companies
  - simpler tax for smaller companies

### Simplifying tax relief for capital investment

#### Accounting depreciation or capital allowances?

- 1.6 The main recommendation on this area in the first report was to explore the use of accounting depreciation in place of capital allowances. This was then the focus of the second report.
- 1.7 At present capital assets are categorised twice, in different ways: first for accounts depreciation purposes and then, separately, for capital allowance purposes.

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<sup>1</sup> <https://www.gov.uk/government/publications/ots-review-of-the-corporation-tax-computation-tor>

<sup>2</sup> <https://www.gov.uk/government/publications/ots-review-on-simplifying-the-ct-computation>

<sup>3</sup>

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/640563/CX\\_letter\\_corporation\\_tax\\_August\\_2017.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/640563/CX_letter_corporation_tax_August_2017.pdf)

<sup>4</sup> <https://www.gov.uk/government/publications/ots-starts-new-review-on-capital-allowances-and-depreciation>

<sup>5</sup> <https://www.gov.uk/government/publications/ots-review-on-simplifying-tax-relief-for-fixed-assets>

<sup>6</sup> <https://www.gov.uk/government/publications/chancellor-responds-to-ots-review-on-tax-relief-for-fixed-assets>

- 1.8 The idea was that using accounting depreciation as the basis for giving tax relief for capital expenditure would remove the need to categorise assets a second time purely for tax purposes. This could remove a major administrative burden and better reflect the commercial costs involved. It could also help open the door for tax to follow the accounts more widely.
- 1.9 However, the OTS concluded that while there were attractions with this in principle, the effort involved in transitioning to such an approach would not be worth the upheaval involved, as:
- it would involve all businesses in process change even though only 30,000 businesses regularly claim capital allowances in amounts that exceed the £200,000 Annual Investment Allowance (and only 8,500 all the time),
  - it would involve a significant cost to the Exchequer if it applied to the whole range of depreciated assets, which it would need to do to achieve the administrative benefits.
- 1.10 The Chancellor's response made it clear that this 'negative' finding was as helpful as a positive one.
- 1.11 The report highlighted the lack of relief for buildings and structures, which the government addressed in Budget 2018 by introducing a new structures and buildings allowance. It was then announced in the March 2020 Budget that the rate of this allowance would increase to 3%.
- 1.12 This new allowance has clearly helped to address the distortion resulting from the absence of any relief for structures and buildings.
- 1.13 While the allowance does not necessarily reflect the economic life of the asset in question and its mechanics operate differently from capital allowances (which adds one kind of complexity), it does provide a consistent approach across businesses. Although merging the new allowance with one of the existing categories (such as for fixtures) might have been simpler in some ways, it would either have been more costly or involved a greater reduction to the rate of relief there.
- 1.14 Overall, the new relief represents positive progress and, in keeping with the OTS's own recommendation, the OTS does not currently propose to consider further structural changes.

### Capital allowances generally

- 1.15 Separately from such fundamental questions, the reports made a range of other recommendations about capital allowances. In the current context, those which the OTS considers call for comment or specific ongoing consideration are as follows.
- 1.16 One recommendation was to introduce a de minimis level for capital expenditure, of say £1,000, below which all expenditure would be treated as on revenue account; alongside discussion of the future of the short life asset regime.
- 1.17 The OTS no longer considers that the £1,000 de minimis idea should be taken forward. This is because the cost to the Exchequer of such a change (in relation to businesses whose expenditure is not covered by the Annual

Investment Allowance), coupled with the need to guard against large purchases being disaggregated into smaller ones through anti avoidance provisions, make this a less attractive prospect than initially hoped.

- 1.18 The OTS is however giving further consideration to the administrative complexities of the short life asset regime as part of its current claims and elections review.<sup>7</sup>
- 1.19 The OTS also recommended reviewing the processes around the elections made to allocate sale proceeds between building and fixtures between purchasers and sellers, under section 198 CAA 2001. The OTS is picking this area up in more detail in its current claims and elections review.

### Aligning tax rules more closely with accounting rules generally

- 1.20 The OTS has often considered whether tax could more closely follow accounting rules generally.
- 1.21 This would usually better reflect the commercial performance reported by companies, reflect the fact that many areas of business tax are now aligned with accounting, and remove or reduce the administrative work involved in carrying out separate processes specifically for tax purposes.
- 1.22 Taking steps to more closely align tax rules with accounting across the board was accordingly one of the themes of the recommendations in the corporation tax report.
- 1.23 Specifically, the report recommended that consideration be given to
- aligning the tax distinction between capital and revenue with the accounting approach
  - aligning the rules for trading deductions and those for management expenses
  - ensuring all business expenditure attracts relief unless specifically disallowed
  - removing the schedular system (under which different sources of income are subject to different tax calculation rules) in favour of a single whole business approach
- 1.24 This approach built on the loss relief changes from 2017, which broadly means that when post-April 2017 losses from different sources are carried forward they are relieved against total profits, albeit with restrictions for larger companies and groups or where a trade has become small or negligible in size. (Previously one of the main effects of the schedular system was to restrict the extent to which losses from some sources of income could be set against profits from others).
- 1.25 The Chancellor's response to the review recognised these were sensible long-term objectives, but noted they would involve a significant upheaval of the

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<sup>7</sup> <https://www.gov.uk/government/consultations/claims-and-elections-call-for-evidence>

detailed tax rules - not least in relation to the consequential changes involved, and could present costs and risks to the Exchequer.

- 1.26 The OTS continues to consider that such changes would bring simplification, albeit with a likely Exchequer cost. While recognising the challenges involved in making a deep change of this kind to the system, the OTS would want the government to ensure that future policy changes make this easier rather than more difficult. The OTS also notes the potential for progress in relation to micro companies, as discussed below.
- 1.27 The report also drew attention to wider links with Making Tax Digital (MTD).
- 1.28 It remains to be seen what approach the present government will adopt in relation to MTD for corporation tax. If it proceeds the OTS would want the government to explore opportunities to streamline the tax system in conjunction with this. It should be recognised that, as with MTD for income tax, developing MTD for corporation tax would be fundamentally more complex than VAT.
- 1.29 In particular, the great majority of companies do not presently produce quarterly accounts and many accounting and tax adjustments operate by reference to accounting periods as a whole. Part of the reason for the relative success of MTD for VAT is that it simply represents a new method of filing the existing quarterly (or monthly) returns.
- 1.30 In particular, it would be important to integrate MTD for corporation tax with any continued requirement for iXBRL tagging. There would also be benefits for some taxpayers and their agents if it fully embraced and automated the administration of tax repayments on loans to participators.
- 1.31 The OTS would be pleased to contribute to government thinking in this area.

### Addressing issues affecting the largest companies

- 1.32 The great majority of companies are small (in 2016 1.5 million of the 1.75 million UK companies had under 10 employees), but the largest companies pay by far the greatest proportion of corporation tax (in 2014-15, the 60 largest payers contributed 16% of all corporation tax).
- 1.33 It is generally expected that large companies will have high-quality advice and accordingly be better placed to handle the complexity inherent in their businesses. For them, simplicity is relative, and is often about the stability of the environment they are operating in and the degree of tax certainty that is realistic and proportionate for them to be able to secure.
- 1.34 In the light of this, an overarching theme of the report concerned the government's approach to tax consultations and the provision of tax certainty. In this regard the OTS welcomed the embedding of the new Budget timetable and tax policy-making process in Autumn 2017<sup>8</sup> and the changes made to HMRC's Large Business Risk Review process from

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<sup>8</sup> <https://www.gov.uk/government/publications/the-new-budget-timetable-and-the-tax-policy-making-process/the-new-budget-timetable-and-the-tax-policy-making-process>

September 2019 (after consultation<sup>9</sup> and piloting). It is possible the OTS may do further work in due course in relation to non-statutory clearances.

- 1.35 Also, it is encouraging that the government brought forward proposals in the March 2020 Budget to revise the treatment of pre-2002 intangible fixed assets so that most corporate intangible assets will now be relieved and taxed under a single regime for acquisitions from 1 July 2020.<sup>10</sup>
- 1.36 Among its other specific technical recommendations, the OTS will particularly encourage the government to continue to consider the following:
- there can be a disproportionate burden in making and reporting small adjustments for UK-UK transfer pricing adjustments, and in relation to penalties that can arise even where any adjustments needed are self-cancelling
  - the scope to remove overlapping or legacy anti-avoidance legislation, or for greater clarity to be available about situations where provisions such as the 'unallowable purpose' test would not apply in practice

### Simpler tax for smaller companies

- 1.37 Given the very large proportion of companies that are small, the OTS report gave particular focus to how corporation tax might be made simpler for smaller companies, not least the 1m or so known as 'micro' companies (which meet two of the following three conditions: turnover of £632,000 or less, balance sheet of £316,000 or less and no more than 10 employees).<sup>11</sup>
- 1.38 One possibility could be to exclude specific corporation tax regimes from applying to standalone micro companies or to build in de minimis limits or caps on more of these regimes (as there are for the interest restriction rules and in effect for the loss restriction rules) to minimise the extent to which they affect the corporation tax position of such companies. Alongside that one could radically streamline the operation of other rules, such as the loan relationship regime. It is worth noting that while these provisions may not actually affect the substantive corporation tax position, they can have an impact on tax compliance.
- 1.39 A broader approach, which the OTS's report recommended exploring, would be to follow the accounts more closely, at least for businesses using the small company accounting standard (FRS 105<sup>12</sup>), and to require only an absolute minimum of tax adjustments - effectively removing the schedular system for these companies. The OTS has engaged with HMRC about their ongoing consideration of this since the publication of the report.

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<sup>9</sup> <https://www.gov.uk/government/consultations/consultation-on-the-business-risk-review>

<sup>10</sup> <https://www.gov.uk/government/publications/corporation-tax-treatment-of-intangible-fixed-assets-from-1-july-2020>

<sup>11</sup> <https://www.gov.uk/annual-accounts/microentities-small-and-dormant-companies#:~:text=Micro%2Dentities%20are%20very%20small,10%20employees%20or%20less>

<sup>12</sup> <https://www.frc.org.uk/accountants/accounting-and-reporting-policy/uk-accounting-standards/standards-in-issue/frs-105-the-financial-reporting-standard-applicable>

- 1.40 The minimal number of tax adjustments would probably be
- disallowing expenses not incurred for business purposes
  - disallowing entertaining expenses
  - disallowing fines, penalties and bribes
  - a rule about uncommercial transactions
  - disallowing unpaid remuneration or pension contributions
  - disallowing some capital items
- 1.41 These adjustments broadly mirror corresponding provisions in the cash basis rules for self-employed people (noting that companies cannot account on a cash basis under current company law).
- 1.42 It would then follow that other rules or reliefs did not generally apply. So, the loan relationships legislation would no longer require bank interest to be split out separately as it is under the present schedular system, and foreign currency transactions would simply follow the accounting position. However, it could also mean that if the company wished, for example, to claim more complicated reliefs (such as research and development relief or structures and building allowances) it would need to opt into full corporation tax.
- 1.43 Perhaps the biggest issue that arises though, if this sort of approach were to work effectively for a wider range of smaller businesses (rather than only for personal service companies or freelancers), is what to do with capital expenditure on plant and machinery.
- 1.44 At present the Annual Investment Allowance (AIA) means micro businesses can write off all their capital expenditure on plant and machinery (other than on cars) in the year it is incurred. Following the accounts entirely would mean allowing only the accounting depreciation, which would considerably accelerate the timing of tax payments. So, while this could result in a faster rate of allowance in relation to cars, a significant adjustment would be needed in relation to other types of asset to preserve the present cash flow position of such businesses.
- 1.45 One way of addressing this timing issue, for those businesses for which this was material, could be an option to claim an additional deduction in the year an eligible capital expenditure was made of, say, 75% of any eligible expenditure, with this being recouped over the next 3 years. This would give the same result as the AIA if the asset were depreciated on a straight-line basis over 4 years. The company would still need to identify and claim that capital expenditure, and instead of maintaining capital allowance pools would need to track the annual add-back of expenditure.
- 1.46 An alternative, in the absence of changes to company accounting rules, would be to consider retaining the main capital allowance rules, including the annual investment allowance (and continuing to disallow depreciation). This would involve specific adjustments to the accounting profit or loss but has the benefit of retaining a single system in corporation tax and a way of giving upfront relief that is already relatively well understood, which could

help this became a default approach for micro companies in practice. Tax agents would also find they only needed to explain a single system for giving tax relief for capital expenditure.

- 1.47 More widely, there would be a risk that companies would opt to adopt this whole approach only if it was in their interests overall - taking account of the administrative differences, different timing of tax payments and any extent to which the overall amount of tax paid was affected. In particular, under the concept of 'best advice' tax advisers are likely to need to consider the relative advantages of making this choice, potentially adding to the work done rather than reducing it.
- 1.48 One possible way to handle this aspect could be to make the simpler approach to corporation tax mandatory for companies using FRS 105, creating a direct link between the choice of accounting standard used and the corporation tax regime, but at the cost of imposing transitional costs on all companies using FRS 105. This approach would not work if companies needed to opt out of a simpler regime to claim more complex allowances, as already mentioned.
- 1.49 While potentially simpler for the very many companies which stay small, this approach would not be envisaged as suitable for companies which intend to grow (which would otherwise need to switch to full corporation tax, and indeed away from FRS 105, at some point).
- 1.50 Another significant consideration is whether this sort of approach could be integrated into a single administrative process along with filing accounts at Companies House. This idea featured in the OTS's recommendations both in the corporation tax report and in the May 2019 *Simplifying everyday tax for smaller businesses*<sup>13</sup> report.
- 1.51 Inevitably, given the present very light touch accounts filing requirements, HMRC are likely to still require more detailed profit and loss account information than those accounts provide to inform its compliance activities. (Companies file publicly only an abbreviated balance sheet and do not need to include a profit and loss account at all.)
- 1.52 The OTS looks forward to seeing where HMRC's work in this area leads and to continue contributing to it if it is decided to pursue a simpler approach to corporation tax for smaller companies. The OTS may also revisit this area if any changes were to be made to company law or accounting standards relating to micro entities.
- 1.53 More generally, the OTS will continue to encourage HMRC to progress related recommendations in the OTS's *Simplifying everyday tax for smaller businesses* report, including on
- building agent needs and access into HMRC system design improvements
  - exploring ways to reduce the number of companies having to file two tax returns to cover first accounting periods that are slightly longer than 12 months.

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<sup>13</sup> <https://www.gov.uk/government/publications/simplifying-everyday-tax-for-smaller-businesses>

## Chapter 2

# Personal service companies, employment and self-employment

- 2.1 Looking at how corporation tax might be made simpler for smaller companies leads naturally into a wider discussion of the position of those who work through their own personal service company.
- 2.2 This is an area which the OTS<sup>1</sup> and many others within and outside of government has considered from various angles in recent years, along with a range of related issues.
- 2.3 This section brings together a stock take of a range of the OTS's work relating to small companies, including personal service companies, those who provide their services to engagers through them, tax reporting and payment arrangements for self-employed people, the boundary between employment and self-employment and related differences in the incidence of income tax and National Insurance Contributions.

### Personal service companies

- 2.4 While there are material differences in the tax position of employees and self-employed people, in particular because of Employers' National Insurance Contributions,<sup>2</sup> discussed below, the position of those working through personal service companies has probably generated even more controversy.
- 2.5 Working through personal service companies makes it possible to share, or defer, the distribution of income received by the company as dividends, so that it is taxed at a lower rate.
- 2.6 If the owner is in a position to significantly defer the distribution of income, then it may be realised in capital form when the company is sold or wound up. In some cases, funds may be retained for investment, although work from the IFS in 2019 using anonymised HMRC data suggested that a large majority of companies do not make any substantial investment.<sup>3</sup>
- 2.7 The use of personal service companies has grown alongside the gradual reduction in corporation tax rates from 28% and 21% in 2010 to 19% in

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<sup>1</sup> For example, in its 2015 employment status review, its 2016 small company taxation review and its 2017 focus paper on the gig economy

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

<https://www.gov.uk/government/publications/the-gig-economy-an-updated-ots-focus-paper>

<sup>2</sup> <https://www.gov.uk/government/publications/simplifying-everyday-tax-for-smaller-businesses> para 3.13ff

<sup>3</sup> <https://www.ifs.org.uk/publications/14241>

2017 which added to the attractions of incorporation, though this has been reduced by changes in the rules about the taxation of dividends from April 2016 and April 2018.

- 2.8 Personal service companies are also used because, as noted in the OTS 2016 Small Company Taxation review,<sup>4</sup> it is commonplace that agencies and other engagers will only engage those who have incorporated. This is on the basis that this will help safeguard engagers from employment rights obligations, the costs of Employers' National insurance and the risk of later finding themselves liable for PAYE.<sup>5</sup>
- 2.9 The April 2017 change to the off-payroll working rules (sometimes known as IR35), required public sector engagers to assess the tax employment status of individuals who work for them through their own personal service company (rather than the personal service company making that determination). This change is to be extended from public sector to large and medium sized engagers in the private sector as from April 2021 (having been postponed from April 2020 as part of the government's Covid-19 response package, recognising the significant change involved).<sup>6</sup>
- 2.10 The aim of these rules is for the engagers, or feepayers, to apply PAYE to such individuals if they would have been an employee if they had provided their services directly rather than through a personal service company. At present the PAYE obligation falls on the personal service company and HMRC's firm view is that there has been substantial non-compliance.

### Previous OTS work

- 2.11 The OTS has considered a variety of approaches to simplifying the experience of those operating through personal service companies, not least in the 2016 Small Company Taxation review<sup>7</sup> and as reflected in the discussion above about a simplified form of corporation tax for smaller companies.
- 2.12 Much of the focus of this work was on reducing the greater administrative burdens that come with being incorporated as compared with being a sole trader, in particular in having to prepare company accounts - which, along with dealing with corporation tax, is nearly always done by accountants.
- 2.13 One idea the OTS explored was for sole traders to be able to register as a 'Sole-Enterprise with Protected Asset' (SEPA), to gain a limited level of main asset protection but without otherwise changing their legal or tax status. This was the subject of a further specific paper later in 2016.<sup>8</sup>
- 2.14 The idea was that those for whom limited liability was the key driver for incorporation would find that becoming a SEPA would give them an alternative route to a degree of limited liability without the administrative

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<sup>4</sup> <https://www.gov.uk/government/publications/small-company-taxation-review> para 2.15

<sup>5</sup> This was the premise of the IR35 legislation, which provided that engagers did not need to consider status where the contractual service provider was a company.

<sup>6</sup> <https://www.gov.uk/government/news/off-payroll-working-rules-reforms-postponed-until-2021>

<sup>7</sup> <https://www.gov.uk/government/publications/small-company-taxation-review>

<sup>8</sup> <https://www.gov.uk/government/publications/ots-final-report-on-sole-enterprise-with-protected-assets-sepa>

burdens of incorporation. This idea has not been picked up, however, and is not pursued here.

- 2.15 Secondly, the OTS considered the potential for personal service companies to be taxed on a 'look-through' basis.
- 2.16 The idea here was that the company would to an extent be disregarded, its profits being calculated on an income tax basis and then divided between - and taxed on - its shareholders as if they were partners. It was developed with a view to being suitable for companies which were in effect one-person businesses with a low turnover and which did not need to retain profits for investment.
- 2.17 The OTS's report on this, also later in 2016,<sup>9</sup> concluded this would not be a simplification overall, mainly because even though the income tax computation could be carried out on a cash basis it would still be necessary to prepare company accounts on an accruals basis, and because it would be difficult to define which companies did not need to retain profits. That would in turn lead to the need for an optional system which would inevitably be chosen mostly by those who would benefit.

#### Possible future OTS work

- 2.18 In the OTS's Small Company Taxation review, consideration was also given to other possible legal forms which small businesses could take, but little if any work has been done since in this respect. Given the continued growth in the number of self-employed people, the gig economy and the number of small companies, it seems worth revisiting this area.
- 2.19 One of these possibilities was the potential for legislative changes to enable the formation of single-member limited liability partnerships which, while needing to prepare accruals accounts, would provide the combination of limited liability and a transparent or look-through approach to tax. It would not however be a familiar type of vehicle to many of those carrying on micro businesses, or their customers.
- 2.20 Here is however another approach, which the OTS considers it would be fruitful to re-examine.
- 2.21 Specifically, the OTS suggests renewed consideration of an approach owing something to S-corporations in the United States of America,<sup>10</sup> to enable a small personal service style business to operate through a UK limited company, while being treated as transparent for tax.
- 2.22 The US S-corporation achieves that status through filing an election with its shareholders, which applies for tax purposes. There are specific requirements that the company and its shareholders must satisfy to be able to make the election.
- 2.23 Features of this sort of approach in the UK context could be that

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<sup>9</sup> <https://www.gov.uk/government/publications/ots-final-report-on-lookthrough-taxation>

<sup>10</sup> See <https://www.gov.uk/government/publications/small-company-taxation-review>

- the limited company would, as now, be registered at Companies House (and treated in the same way as existing limited companies under company and employment law)
  - the company would be transparent for income and corporation tax purposes, so would not be taxed itself<sup>11</sup>
  - any salaries, dividends or loans to directors or other participators would be ignored for all tax purposes
  - its income or capital profits, whether distributed or retained, would be taxed on the directors or other participators as if received as income or profits from self-employment
- 2.24 The aim would be to provide small personal service type businesses with a fully recognisable form of limited liability, removing them from corporation tax (though accounts would still need to be filed at Companies House), together with the relative ease of a self-employment style tax calculation.
- 2.25 There could, separately, be the potential for this self-employed style calculation to be on a cash basis, as for self-employed people generally. However, unless company law were to be changed to permit a company to file accounts on the cash basis, this would be of limited assistance generally as there would still be a need for accruals accounts for company law purposes (though it could be of some benefit to those companies using FRS 105).
- 2.26 If the off-payroll working tests (IR35) applied to any part of the activities carried out through the company, the engager or feepayer would apply those rules as they would in relation to any other company, with the relevant income being treated as received by the shareholders as employment income, outside of the self-employment-style calculation relating to the company.
- 2.27 A key question would be whether such a regime would be elective or not. Making it mandatory would involve significant challenges in defining the companies to which it applied. However, for a tax-transparent company approach of this kind to be an effective driver of simplification, then as well as addressing any other specific interactions with tax, employment or company law, it would be important that people would not lose out as a result of taking up such an option<sup>12</sup>.
- 2.28 This means it would work best in the context of wider changes to the general taxation rules for small companies, for example to increase the tax rates applicable to dividends or to tax more of the retained earnings of such companies as they arose (at income tax rates) unless they could be seen to be being used or needed for investment. Defining and operating a regime of this kind would also need to manage the risk of reintroducing problems

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<sup>11</sup> Though it might be that the company rather than the shareholders would be liable for VAT and other indirect taxes.

<sup>12</sup> In the United States of America, the S-corporation regime became popular in a context of high general corporation tax rates.

encountered with the pre-1989 'apportionment' regime for close companies.<sup>13</sup>

- 2.29 Alternatively, it might be easier to limit this option to companies using FRS 105 accounts (or to consider making it mandatory for those with very limited capital assets on their balance sheet if that proved possible to police).
- 2.30 The question is what the relative costs, difficulties, risks and benefits would be of
- a) transparent company approach – with all the earnings of such small companies being taxed along self-employed lines
  - b) developing a modified and to an extent simpler approach to corporation tax itself for small companies, but still involving a calculation different from that applying to other companies
  - c) keeping things broadly as they are
- 2.31 The OTS will continue considering these issues and would welcome contributions from others to this discussion.

## Tax reporting and payment arrangements for self-employed people

- 2.32 Alongside potential changes to simplify things for small companies and those who work through them, the OTS consider there is a good deal that could be done to improve tax administration for self-employed people, as noted in its *Tax reporting and payments arrangements*<sup>14</sup> report in 2019.
- 2.33 The report explored the role that a more developed version of HMRC's Personal Tax Account could play in simplifying the experience of the tax system for both self-employed people and landlords and enable fruitful changes to reporting and payment arrangements. Such developments could make it easier for people to see and keep track of their taxable income, to know what tax may be due, and to make regular contributions towards their tax liability.
- 2.34 In particular, the report recommended exploration of the potential for HMRC to offer a fully integrated Individual Tax Account, providing an end-to-end tax reporting and payment service.
- 2.35 The report recommended that such an Individual Tax Account should:
- merge the present personal and business tax accounts, so that taxpayers could see information about all their different types of income separately in one place
  - be able to receive and display data from taxpayers about their self-employment income (and rental income, where relevant)

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<sup>13</sup> See comments in this 2016 response document to a consultation on dividend taxation  
[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/510263/Company\\_distributions\\_-\\_summary\\_of\\_responses.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/510263/Company_distributions_-_summary_of_responses.pdf)

<sup>14</sup> <https://www.gov.uk/government/publications/ots-tax-reporting-and-payment-arrangements-review>

- offer a running calculation of the additional tax that the individual may need to pay in relation to the year to date, looking across all the information held in the individual's tax account
- offer the facility for the taxpayer to make payments (whether of the calculated amount, or other amounts chosen by the taxpayer) to HMRC towards their overall liability, and to display information about amounts paid
- be able, in time, to receive and display data from third parties in selected sectors who have a significant role in relation to the individual's self-employment or rental business

## Employment status

- 2.36 The long-standing taxation boundary between employment (a contract of service) and self-employment (involving a contract for services) has emerged through the development of case law. The definition of employee is broadly similar for employment law and tax law purposes but there can be differences as the statute law differs and appeals come to judges sitting in separate tribunals.
- 2.37 In employment law, there is also a 'worker' category within which people have some of the rights of an employee and may (or may not) be treated as self-employed for tax purposes - depending on the situation.
- 2.38 In December 2018 the previous government's 'good work plan'<sup>15</sup> committed to legislating to improve the clarity of employment status tests. This followed the Taylor review<sup>16</sup> which had recommended that the employment and tax frameworks should be aligned as much as possible - and that key features of the status tests should be legislated.
- 2.39 The current government has however not yet set out a public position on this issue.
- 2.40 The OTS is interested in the scope to go further in this area, in particular in relation to the possibility of a statutory definition of employment for tax purposes (and whether it would be practicable or desirable for this also to apply for employment law purposes). Such a statutory definition need not be an attempt simply to codify the current case law principles but could have different features.

## Income tax and NICs alignment

- 2.41 Standing behind the issues considered so far are long-standing structural differences between the income tax and National Insurance Contributions treatment of self-employed people and employees.
- 2.42 The OTS considered these most particularly in two reports in 2016:

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<sup>15</sup> <https://www.gov.uk/government/publications/good-work-plan/good-work-plan>

<sup>16</sup> <https://www.gov.uk/government/publications/good-work-the-taylor-review-of-modern-working-practices>

- the first (in March 2016<sup>17</sup>) looking at bringing the two systems into closer alignment generally,
- the second (in November 2016<sup>18</sup>), which looked in more detail at the implications of the possibility of employee's NICs operating in the same way as PAYE

2.43 The key areas for future consideration in relation to people whose work can realistically be done either in a self-employed capacity, through a personal service company or as an employee, are:

- aligning self-employed people's NICs and benefits more closely with those for employees.
- moving to an annual, cumulative and aggregate basis for employee NICs
- bringing taxable benefits in kind into Class 1 NICs
- aligning the definition of earnings and expenses for income tax and NICs

2.44 Neither report considered the very substantial difference in treatment of pension contributions for NIC purposes: employer contributions are not liable to NIC, whereas there is no NIC relief for employee or self-employed pension contributions.

2.45 The Chancellor noted in his November 2016 response<sup>19</sup> to these reports that progressing this agenda would involve a range of challenges.

2.46 In particular, one significant challenge, highlighted in the November report, is that bringing employee NIC onto an annual, cumulative and aggregate basis – to mirror income tax – was estimated to involve 5.5 million people paying more NICs and 7.6 million people paying less NICs.

2.47 Two subsequent events help highlight the extent of these challenges.

2.48 The first was when, having sought to increase the level of the Class 4 NICs paid by self-employed people in the March 2017 budget, that decision was reversed before being implemented, because it was perceived to have gone beyond the envelope set out in the government's manifesto.

2.49 Nevertheless, as was made clear in the statement to parliament,<sup>20</sup> the government's view was that

*"The current differences in benefit entitlement no longer justify the scale of difference in the level of total national insurance contributions paid in respect of employees and the self-employed. Most notably, the introduction*

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<sup>17</sup> <https://www.gov.uk/government/publications/closer-alignment-of-income-tax-and-national-insurance-contributions>

<sup>18</sup> <https://www.gov.uk/government/publications/ots-publishes-further-report-on-the-closer-alignment-of-it-and-nics>

<sup>19</sup>

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/571265/OTS\\_NICS\\_CX\\_\\_letter.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/571265/OTS_NICS_CX__letter.pdf)

<sup>20</sup> <https://hansard.parliament.uk/Commons/2017-03-15/debates/8C87BBE6-1F11-44F8-A01E-1D99ECBD0ACA/Class4NationalInsuranceContributions>

*of the new state pension in April 2016 is worth an additional £1,800 to a self-employed person for each year of retirement."*

- 2.50 That statement, in March 2017 reaffirmed the government's commitment to abolishing Class 2 NIC:

*"We will go ahead with the abolition of class 2 national insurance contributions from April 2018. Class 2 is an outdated and regressive tax, and it remains right that it should go."*

- 2.51 However, there was then a second event, which led to the abolition of Class 2 NICs, which was intended to simplify the system, being put on hold.

- 2.52 Initially, in November 2017, the proposed change was delayed a year<sup>21</sup>:

- 2.53 But then in September 2018 it was decided not to proceed with this change during that parliament,<sup>22</sup> given the increases in voluntary payments that self-employed individuals with This suggests that what is needed is a broader consideration within government of a suitable approach to resolving these issues, including the communication and development of a package of changes that can be implemented in a more coordinated way.

- 2.55 Such an approach would be one way of taking forward what was perhaps hinted at by the present Chancellor in conjunction with the 26 March 2020 announcement<sup>23</sup> of the Covid-19 support package for self-employed people, when he said:

*"It is now much harder to justify the inconsistent contributions between people of different employment statuses. If we all want to benefit equally from state support, we must all pay in equally in future."*

- 2.56 The OTS continues to consider and to discuss these issues with government with a view to moving debate forward.

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<sup>21</sup> <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-11-02/HCWS220/>

<sup>22</sup> <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2018-09-06/HCWS944/>

<sup>23</sup> <https://www.gov.uk/government/speeches/chancellor-outlines-new-coronavirus-support-measures-for-the-self-employed>