Office of
Tax Simplification

Small company taxation review

March 2016

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Foreword

Small company taxation – charting a path for change

The Office of Tax Simplification (OTS) has done much good work on simplification for small businesses, particularly for partnerships and unincorporated businesses. This time the focus is on incorporated businesses with fewer than 10 employees. These 'micro' businesses now number some 4.1 million in the UK, over 1.3 million of which operate through a company structure. While they are not large employers they are the largest group of incorporated businesses; a company which is large today was small yesterday and all entrepreneurs start small. But many companies choose to stay small and as the business structure of the economy changes this sector is expected to grow.

Shifting attitudes are resulting in more people choosing to contract their services to large companies or by using platforms and other disruptive technologies to obtain their work, rather than being an employee. Whether referred to as 'uberisation' the 'sharing economy' or the 'gig economy' these different ways of working are expected to accelerate. In this context, the importance for simplifying the tax maze for micro companies is clear.

This review has found that among the many reasons for incorporation, the three main ones for micro companies are to limit their liability, to enhance their credibility and to provide a formalised structure. And, importantly, that a combination of many small issues means 76% of them believe it is safer to leave corporation tax to their accountant than to do it themselves.

Perhaps not surprisingly, this results in the OTS listing a series of administrative changes as being high on micro companies' wish lists. These range from a 'one stop HMRC shop' approach to an out of hours service, helping to reassure companies trying to do the right thing when things go awry; and from a desire for a truly digital service that provides pop-ups and prompts as on line forms are being filled in through to a system which links Companies House and HMRC.

In this context the OTS highlights three areas which we consider warrant further investigation. The first is known as 'look through', which means that instead of paying corporation tax, a company's shareholders would pay income tax on the profits directly. Many respondents to the OTS consultation were strongly in favour of this – but with just as many strongly against. While unlikely to be suitable for growing companies, this could offer simplification for the majority who distribute all their profits. To ensure the detail and impacts of this approach are properly understand the OTS proposes to explore 'look through' further, to prompt an informed debate.

Turning to the second big issue, there's nothing new in saying the current system puts a disproportionate administrative burden on micro companies, who face the same accounting and tax system as large companies with hundreds of employees and turnovers of many millions. Our review found that incorporation brings benefits for micros, but - as shown in an earlier OTS review on unincorporated businesses - cash accounting for tax is easily the simplest, and an appropriate, approach for this size of business. What is good for unincorporated micro businesses is potentially good for incorporated ones. So we recommend this is explored further.

Thirdly, we propose to look further at a 'sole enterprise protected assets' structure which could give a sole trader the key aspects of the liability protection they currently incorporate to secure.

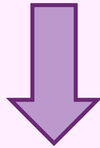
In these and other ways outlined in the report, the tax environment for the UK's micro companies can be simplified.

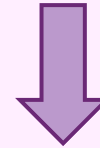
Angela Knight, Chair, Office of Tax Simplification

Small company taxation

Currently

A corporate tax regime on a one-size fits all basis modelled on a traditional company with third party shareholders and intending to grow





Simplification areas to explore

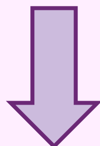
How a 'look-through' approach could work best for certain types of business, clarifying who would gain or lose, and the pros and cons of this being compulsory.

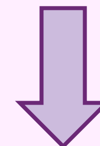
Whether an alternative legal structure would give some businesses what they need without them having to be a company, and make their tax obligations simpler.

Simplification improvements to take forward now

Streamlined, joined up registration and reporting processes including between HMRC and Companies House.

Simpler corporation tax calculations to facilitate digital returns, including more use of cash basis.





A remodelled small company landscape

A tax environment in which business structures and tax obligations are simpler because they are better matched to the needs of different types of small business

Simplifying small company taxation – how the OTS developed its path for change

This project has seen the OTS return to familiar ground but take forward our studies in a different direction: We first looked at simplification for small (unincorporated) businesses; then moved on to partnerships; now we complete the trilogy by looking at small companies.

Taxation is inevitably going to be a burden for business; our brief is to look at ways of easing that burden. The actual rates of tax are outside our scope (unless they cause specific complexities); instead we've looked for ways to simplify both technical and administrative matters that small companies have to deal with.

We have looked at alternatives to the current tax system, including alternatives to the company structure. We've looked round the world (sadly by e mail and phone call rather than actual visits!) at how other countries tax – and encourage – small companies. Some use 'look-through' – taxing the company by allocating its profits to its proprietors and taxing them directly – an idea we have previously noted and which I have long wanted to look at properly for the UK. On the surface the concept of ignoring the company and simply taxing the owners – who would be taxed anyway – sounds attractive. Could it work here? Would it really simplify things in practice?

As always, we have been very fortunate in the amount of input and support we have had from a huge range of stakeholders: businesses of all sizes, representative bodies, advisers, academics, unions, charities and HMRC staff. It has been very stimulating to talk direct to businesses from Belfast to Berwick, from Edinburgh to Exeter, from Suffolk to South Wales; it is also gratifying that 285 businesses responded to our online survey. We very much appreciate the time and input we have had from representatives of countries ranging from France through Hungary to New Zealand. HMRC's Knowledge, Analysis and Intelligence (KAI) team has as always given us valuable support and our Consultative Committee has helped us greatly.

Most thanks, though, are due to those who have done most of the work. The OTS has been fortunate to be able to recruit an excellent team: Andy Richens as project leader, Brian Palmer, David King, Rebecca Seeley Harris and Suzanna Ingham. We are very grateful to PricewaterhouseCoopers who generously made Suzanna's time available. Although nominally working two days a week each, all have put in a lot more time than that! Thankfully we were joined by Aaron Yamoah as our project manager: the project was already well under way when Aaron joined but he has put in a huge amount of work to get us coordinated and managed, so that we could get a coherent report. Overall, we've put in about a man year of work into the project – not much for such a big subject but we have undoubtedly made real progress.

Digital possibilities were always going to be major considerations in our recommendations. But part way through our work came the announcements in the Autumn Statement, amplified subsequently, about HMRC's Making Tax Digital (MTD) plans. These naturally were much on the minds of our stakeholders in the latter stages of our evidence gathering. It is not for the OTS to evaluate the MTD ideas, but we have tried to take the principles into account. In fact we would have been recommending digital improvements without MTD; we think MTD gives added impetus to some of our ideas around streamlining the corporation tax computation.

We believe we have arrived at a good package of recommendations that can make a real difference and simplify the tax system for our target companies. Some are things that can be done quickly; others are medium term and still more are ideas for ways that the system could be radically reshaped. Many will require more work and we have indicated where we think the OTS should be taking things forward: please let us have your comments and feedback as we do so.

John Whiting, Tax Director, Office of Tax Simplification

1 Executive review

Introduction

1.1 This review presents recommendations to the Chancellor of the Exchequer and Financial Secretary to the Treasury on how to simplify the tax system for small companies, increase certainty and reduce administrative burdens. The review builds on the OTS's earlier projects on simplifying the tax system for unincorporated businesses. The detailed terms of reference[1] for the review were published at the outset on 21 July 2015.

1.2 As with the review for unincorporated businesses, this review is largely focussed on the smallest companies - those with fewer than ten employees, often referred to as micro-companies. However, we have had regard to all companies with less than 50 employees when conducting this review. In fact, a lot of our thinking has been around companies that we term 'nano': typically those with one working proprietor and either none or only one other employee. We have also considered the impact of any simplification in these areas on other business sectors, particularly small unincorporated businesses.

1.3 In keeping with the terms of reference for the review, we have not explicitly considered existing intermediaries' legislation (IR35) as the government has issued a discussion document which is running in parallel to this review. However, we have taken note of all references to IR35 raised during our consultations and have made appropriate comments.

1.4 We have taken an open approach to this review, inviting all that are willing to send representations and meeting with stakeholders the country over, from Belfast to Berwick-upon-Tweed. We held 52 meetings and round table discussions with small company owners, representative groups, accountants and tax experts. We have also had input from international counterparts and government organisations. See Annex G for a listing.

1.5 We surveyed 285 small company owners across 18 of the 21 Companies House business sectors[2] with a distribution that broadly reflects the expected total population – based on population data of micro businesses. We did not draw any conclusions directly from the survey, but used it to provide reassurance that the information we collected from meetings reflected the views of the wider small company community: full analysis of the survey results is at Annex F. We also surveyed and met with HM Revenue and Customs (HMRC) frontline staff, and HMRC and HM Treasury policy officials.

1.6 This report presents our findings and recommendations from these discussions. We cannot claim to have discovered all complexity issues facing small companies but we think we are giving a fairly complete picture in this report. There is always scope to do more investigation but we are satisfied we have solid evidence on which to base our recommendations. Areas for further review are highlighted within this report's recommendations.

1.7 The report has two sections. This executive review provides an overview of our findings and recommendations and then the following chapters provide a deeper dive into key themes raised

[1] https://www.gov.uk/government/publications/ots-review-of-small-company-taxation-tor

[2] No companies responded from sectors D, O, and U, which is somewhat expected as these are sectors where one would expect very few small companies to exist. These sectors are: Electricity, gas, steam and air conditioning supply; Public administration and defence, compulsory social security; and Activities of extraterritorial organisations and bodies

within the report. The intention is that each chapter can be read alone, so there is some deliberate overlap between chapters and sections

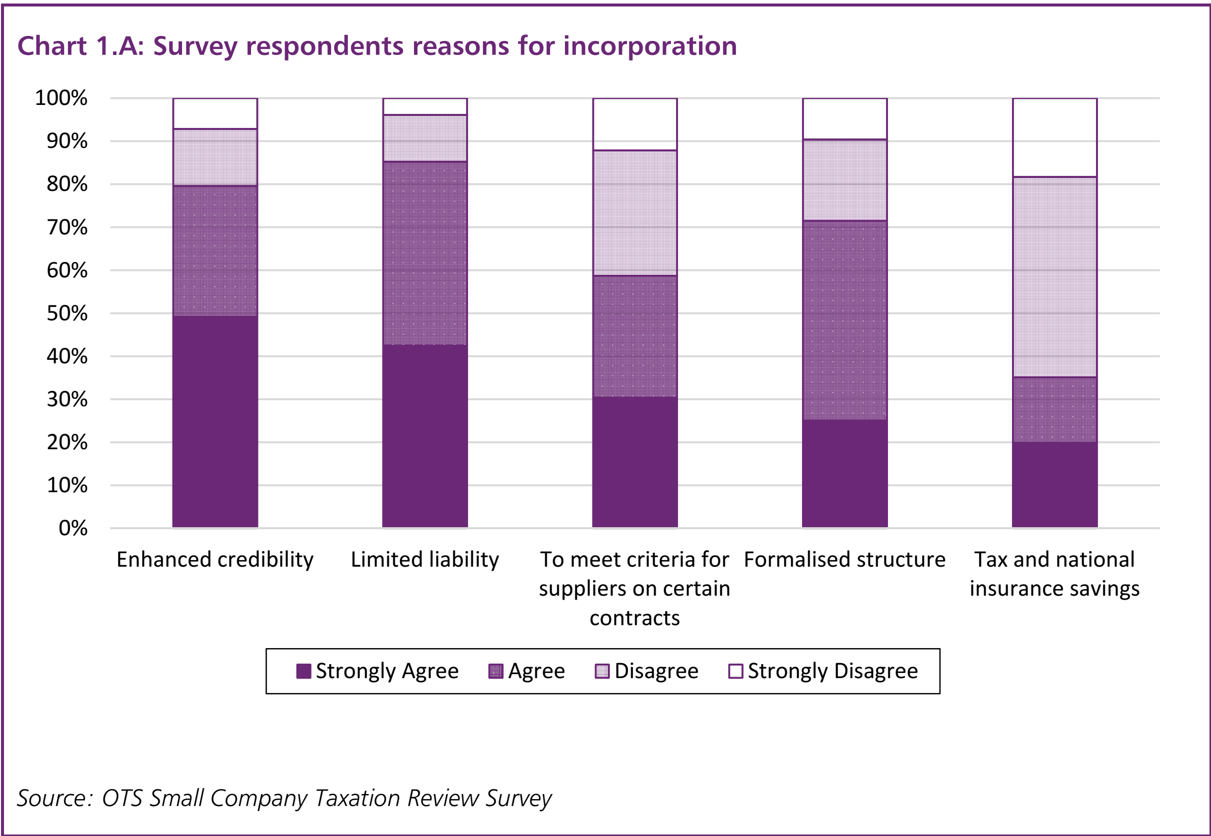
Understanding the small company landscape

What do small companies look like?

1.8 To be able to consider how to simplify the tax system for small companies, one must first understand small companies, including the reasons why they are formed, their structures and the plans and goals of their owners. Small companies are owned and run by individuals who are generally skilled in their sectors and aim to offer services and/or goods. This, and not a prior in-depth understanding of tax administration, is – and should remain – the key prerequisite of company formation. The small company owners and representatives we met consistently made clear that the primary concern of small company owners is the successful running of their business interests, with tax a secondary concern.

1.9 In 2014 HMRC commissioned an independent IPSOS MORI study into the reasons behind incorporation. The main driver for incorporation was found not to be tax but limited liability. This also chimes with the views recorded from our meetings and survey respondents[3].

Chart 1.A: Survey respondents reasons for incorporation



Source: OTS Small Company Taxation Review Survey

1.10 However, some advisers also suggested that a not insignificant proportion of small companies were formed because owners did not understand the full implications of incorporation. Indeed, some believed one had to register with Companies House in order to run a business.

[3] While the survey's list of possible reasons for formation was not exhaustive, it allowed each respondent to state whether each option affected their decision to incorporate. Therefore respondents could strongly disagree with all options if that was the case.

1.11 There is often a perception that the small company landscape is formed of steadily growing companies that were established at some point in time and are at the beginning of a journey that will see them increase in size and turnover until they employ tens or hundreds of employees and have turnover of many millions. Whilst this is true for some small companies, the picture is in fact much more complex; there are a number of specific sub-categories within the micro company population – companies with fewer than ten employees – that do not fit this description.

Types of small companies

1.12 We have identified at least four distinct types of small companies:

- Non-employing companies or single entity companies | Companies formed of one individual that operate in the same way as a sole trader but have the legal form of an incorporated business. Most or all of the profits are extracted from the company with very little retained for investment in anything other than stock. These companies typically dissolve once the trader retires.
- Personal Service Companies | The director is also the sole or main shareholder. They conduct their work under contracts that could otherwise see the director treated as an employee of their customer. However, operation is through a company, often as an attempt to bypass employment law on their customers' insistence.
- Non-growth companies | These companies may represent the typical small company with tangible assets, property and possibly a few employees. However, there is no intention to grow significantly. As with sole trader companies, most or all of the profits are extracted from the company with very little retained for investment in anything other than stock. Many of these companies dissolve once the owner or owners retire.
- Growth companies | These companies fit the archetypical view of small companies: growing from incubation into medium and larger companies. For these companies, the small company phase is merely a transition. A relatively new phenomenon within this space are rapid growth companies - creative and technological start-ups, and trading companies that make use of the internet and modern logistics to rapidly access a very large marketplace.

1.13 As a whole, micro companies make up about 36%[4] of the 3.6 million[5] British companies. With each paying agents an average of £1853[6] plus owners' own time in evenings and weekends, it is clear that any reduction in administrative burdens for micro companies will help HMRC go a significant way towards their £400million administrative burden reduction target[7].

Micro companies' interaction with the tax system

1.14 The UK tax system has not been specifically designed to accommodate modern small company forms. This has caused a fairness issue among the 723,000 nano companies[8] and the

[4] Based on HMRC estimate of at least 1.3 million micro companies in the UK
[5] 3,641,258 UK companies in January 2016 according to Companies House
[6] HMRC Research Report 375 – Understanding Tax Administration for Business
[7] HM Treasury, Autumn Statement 2015, paragraph 1.289
[8] Companies consisting of just one or two owner-directors and no employees.

broarder 4.1million[9] nano businesses[10] of which these are a sub set. They are treated differently by the tax system depending on their legal form, but are all non-employing businesses and, on the whole, do not plan to grow.

1.15 Incorporating creates a significant problem for many micro businesses, especially nanos. Many proprietors simply do not understand the accounting and tax requirements of a company but are comfortable with the requirements of an unincorporated business.

1.16 The tax system also puts disproportionate administrative burdens on smaller companies. Micro companies spend an average of at least 27p in advisory fees for every £1 of corporation tax they pay[11]. While micro companies may gain further benefits from a prepared set of accounts provided by advisers, the primary use for most is to meet the reporting obligations of Companies House and HMRC.

1.17 Simplification on this front also has a key benefit to HMRC. By simplifying the reporting requirements, HMRC can simplify the monitoring and enforcement arrangements for most small companies and better target resource at those who are deliberately abusing the system.

1.18 The easiest way to simplify the tax burden for these companies would be to remove them from the corporation tax system altogether. Given that limited liability is cited as the most common reason for incorporating, we think that there is merit in a system that provides protection for personal assets for sole traders, limiting their personal liability while allowing them to continue to trade as a sole trader with the associated accounting and tax treatment. This is discussed in more depth in the *Legal* chapter. France already has a similar system in place called déclaration d'insaisissabilité (declaration of unseizability) that is covered in greater detail in the *Lessons from other countries* and *Legal issues and alternative forms* chapters. **We recommend that the OTS develops an outline of such a vehicle (a 'Sole Enterprise Personal Assets' or SEPA) to test its practicability and whether it would deliver the desired personal asset protection in practice.** As part of this work we will consider further the single member LLP route noted in the *Legal issues* chapter.

1.19 Such a personal asset protection system would provide something akin to limited liability, but not the assumed enhanced credibility and formalised structure that incorporation provides. In particular, incorporation also provides the separate legal entity that is essential for many personal services companies to win contracts. The vast majority of potential customers in this sector will only award contracts to companies, their main driver being to try and insulate themselves against employment law consequences.

1.20 In our Employment Status report, the OTS considered the idea of a Freelancer Limited Company (FLC). At the time its proponents were putting this forward as an alternative vehicle but we were unconvinced with the idea and in effect challenged them to develop the concept to meet our concerns. We have discussed the idea further and the revised version of the FLC is now essentially:

- A standard limited company;

[9] Department for Business, Innovation and Skills (BIS) Business Population Estimates for the UK and Regions (BPE) 2015 – URN 15/92
[10] Businesses consisting of just one or two owner-directors and no employees. This includes the self-employed.
[11] Calculated from HMRC estimates of the micro company population and corporation tax receipts. It is an estimate and may not be totally accurate as it includes all accountancy expenditure and accountants may also be providing other services beyond, accounts and corporation tax computations.

- With restrictions on its arrangements and activities;
- With the aim of a FLC offering insulation from IR35.

1.21 We think this developed FLC concept is worth considering further. However, given that its key aim is to manage exposure to IR35, we are conscious that it is potentially answering a question we were not asked to consider. We do see that if the criteria for the FLC are properly set it could deliver certainty (and hence simplicity) to a large body of freelancers and contractors. At the same time, we are conscious of the risks involved with seeking to give a route out of the ambit of IR35. **We are not in a position to make a formal recommendation about the FLC, but we or others may return to the subject in future work.**

Accounts, taxable profit and cash

1.22 For many small companies there are three sets of figures they have to prepare or maintain:

- Accounts proper, for eventual publication;
- Tax records and computations, to lead to corporation tax figures;
- Cash records.

1.23 Real simplification could be achieved if these three converge, ideally into one set; if that is not possible two sets would be better than three. We have therefore examined the possibilities of such streamlining.

Accounting requirements: can accounts and cash converge?

1.24 Small companies and accountants told us that, for many, it's not just the tax treatment that is complicated but the requirement to file accounts according to generally accepted accounting principles (GAAP). In simple terms, GAAP are based on accruals accounting rather than cash accounting.

1.25 Accruals accounting is seen as a method to provide in-depth knowledge to shareholders, and a fuller picture to creditors and those planning to do business with with the company. This fuller accounting and related reporting is the 'quid pro quo' for the privilege of limited liability. Clearly full accruals accounting can help owner-directors and is almost essential for businesses with trading stock, but many could have a sufficient picture from cash accounting. Some of the accountants we spoke with raised this as a genuine concern, saying that they often produced accounts that were of little use to the owner because the owners didn't understand the accounts. The accounts simply became a reporting requirement rather than an aid to business.

1.26 It is important to consider accounting requirements when considering tax simplification for small companies. If full accounts are required for reporting purposes, a tax simplification that uses a different set of figures may have only a limited impact. One issue to test with the putative SEPA vehicle, for example, is whether full accruals accounts would be required.

1.27 An efficient way to simplify the tax and accounting system for small companies would be to use a sole trader tax treatment while simultaneously providing for cash accounting. The potential benefits of such an arrangement are significant:

- An accounting treatment that many small company owners are able to understand as it is similar to how many run their day-to-day financial affairs;

- A system that will enable much simpler regular reporting for tax purposes, so likely to facilitate quarterly reporting as proposed under Making Tax Digital (MTD);
- Potentially significant cost savings for small companies through a reduction in accountancy fees;
- Continued benefits of limited liability and a separate legal entity for business operations.

1.28 This approach would make use of the existing sole trader tax and accounting regimes, minimising any additional complexity in the overall tax landscape while providing significant simplification benefits to small companies.

1.29 **Therefore, we recommend that the possibility and practicality of a cash basis of accounting being used for the smallest companies is explored. OTS would be pleased to work with BIS, professional and trade bodies on this.** This recommendation is discussed in more depth in the *Legal* chapter.

1.30 This recommendations would require an exemption from the EU Accounting Directive, which currently requires all company structures with limited liability to file accruals accounts. However, the directive provides scope for simpler 'cash+'[12] accounts from micro-companies. Furthermore, the French government is already attempting to make progress in this area. On 18 January 2016 President François Hollande announced plans "to facilitate the passage of sole trader towards the EIRL13 or a company by relieving the formalities of publishing."[14] These issues and the EIRL is covered in greater depth in the *Lessons from Other Countries* and *Legal issues* chapters.

Aligning taxable profit with accounting profit

1.31 Another approach to simplification would be to align taxable profit more closely with accounting profits. The move to more frequent reporting (or engagement with HMRC) under Making Tax Digital (MTD), and the need to make this obligation as light touch as possible, brings this into sharper focus. In the OTS's UK Tax Competitiveness Report we recommended exploring:

- Whether many of the 'sundry tax adjustments' could be eliminated;
- A general move to taxing the accounting profits with minimal adjustments;
- Tax businesses on business profits rather than streaming between trade and investment;
- Replacing capital allowances with a deduction for depreciation, subject to considering provisions on how to best protect those wishing to claim the annual investment allowance; and

[12] Simplifications under the micro-entities regime, where accruals is only required for revenue. There are exemptions from accruals for raw materials/consumables and staff costs, and no requirement for value adjustments to assets and tax.
[13] *Entreprise Individuel à Responsabilité Limitée* (EIRL) is a French legal form that provides sole traders with limited liability.
[14] http://www.gouvernement.fr/un-plan-d-urgence-pour-aller-plus-loin-sur-le-front-de-l-emploi-3640 (webpage in French)

- Minimising the need to maintain additional accounting systems for corporation tax purposes.

1.32 The government's response to the Competitiveness report was that these recommendations would be considered. As far as this report on Small Companies is concerned, **we reiterate the core recommendation in the Competitiveness report that many of the 'sundry tax adjustments' need to be reviewed and potentially eliminated**. We are aware that small companies usually have fewer actual adjustments but the complexity is there and adds to the burden.

1.33 The other major adjustment between the accounts and the tax computation is for capital allowances. For small companies, these are effectively on a cash basis with the annual Investment allowance (AIA), given that they will have few building purchases. Thus replacing capital allowances with depreciation is likely to be unattractive. Given the AIA, it seems impractical to bring the 'tax profits' fully in line with 'accounts profits'.

A cash basis for taxable profit?

1.34 If harmonising accounting profit and taxable profit is difficult or impractical, what of aligning a cash profit with taxable profit? In other words, calculating taxable profit in terms of cash. With the AIA system, this is what many small companies do – apart from the 'sundry adjustments'. This emphasises the need to eliminate these adjustments so that the company simply claims a deduction for all its business expenses.

1.35 This route clearly fits well with the MTD ideas. To allow the company to make any quarterly return or payment simply on the basis of cash would be simpler. After the year end there may be a need to carry out a reconciliation which in principle could be carried out as the annual accounts are prepared.

1.36 These ideas are embryonic and will depend on how MTD develops. We return to the subject of MTD at the end of this executive review but **we recommend that the OTS is formally involved in MTD's development to ensure simplification issues are considered.**

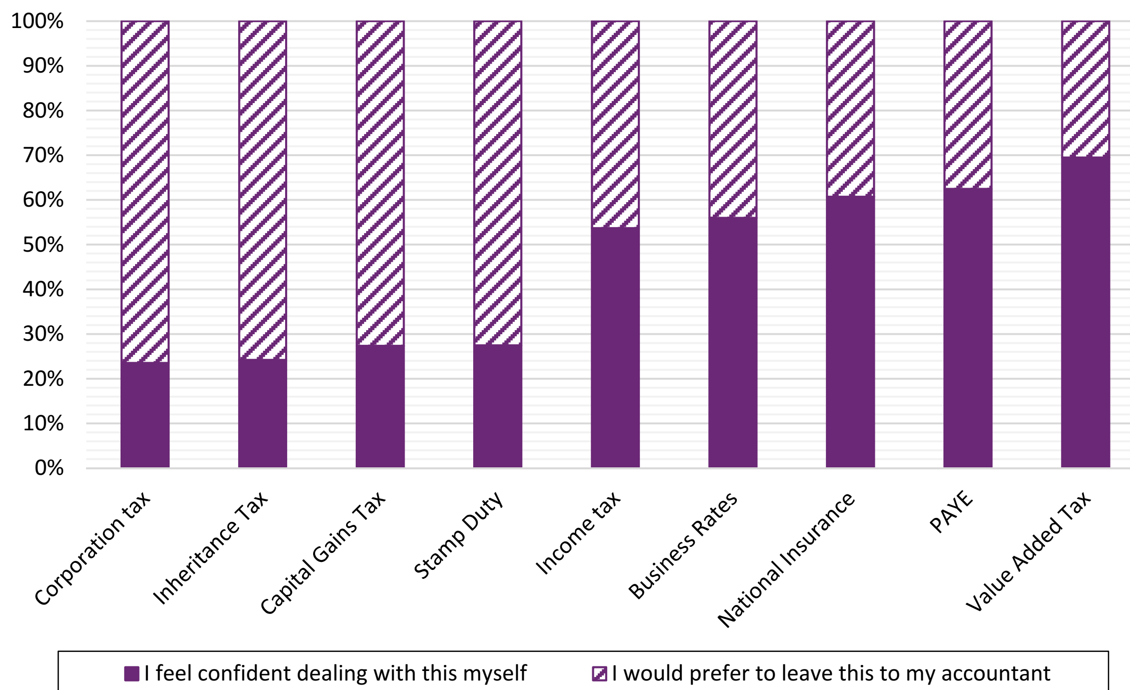
Alternative approaches to taxation

1.37 UK businesses are typically exposed to a variety of taxes throughout their lifecycle including: VAT, capital gains tax, business rates, inheritance tax, income tax and national insurance contributions. In addition, once incorporated, small companies have to make corporation tax returns.

1.38 Many of the small companies we spoke with found corporation tax particularly difficult to deal with, especially when having to account for the various tax exemptions and reliefs. A message reiterated consistently was that the constant changes to the tax system, even when intended to be beneficial, were a complication; stability of the tax system would be a significant simplification in its own right. This reiterates a key finding in our first small business report: that change is the biggest source of complexity.

1.39 As a general point, 76% of our surveyed respondents said that they would rather leave corporation tax to their accountants than get to a position where they felt comfortable dealing with it themselves. This was higher than for any other tax.

Chart 1.B: Which taxes do you feel confident with dealing with yourself and which would you prefer to leave to your accountant/tax adviser (if you have one)?



Source: OTS Small Company Taxation Review Survey

1.40 At this point it is also important to note that non-domestic rates (NDR or business rates) issues were raised by a significant number of respondents. Although not under the remit of HMRC, we have taken note of the comments as we want to bear in mind all taxes and duties that impact on small businesses as set out in the terms of reference for this review. The primary concern was not the complexity of NDR but their distortionary impact. Various reforms, were suggested to us which we summarise in *Structure of Company Taxation* chapter but we are conscious that the reform of NDR is actively being considered by HM Treasury and we do not intend to consider it in any detail in this report.

1.41 As set out in our terms of reference, we have also researched and reviewed potential alternative taxation approaches to the current corporation tax system. Each of the approaches reviewed was supported by some of the small company owners, advisers and representative bodies that we met with, although none commanded universal support. In each case we have sought to discern:

- Whether such a system should be operated as compulsory, optional, or by default with an opt out;
- Which companies would be included; and
- Whether such an approach represented simplification.

A look-through basis

1.42 A number of countries operate a 'transparent' tax. This is where small company profits are taxed directly on the shareholders, with the company itself paying no form of corporation tax. We have considered a specific form of transparent tax called look-through. This would mean the

shareholders being assessed to income tax and national insurance contributions (NICs) on their share of the profits. Dividend distributions would not be subject to tax as the profit share would already have been charged.

1.43 Of all the topics we covered during this review, none were more divisive than look-through. Respondents were generally either strongly against or strongly in favour; with accountants and tax advisers generally against, small company owners generally in favour and representative groups and bodies split between the two camps. One area where virtually all respondents were in agreement was that if any look-through scheme was introduced, it should not be compulsory, though that raises concerns with the OTS about adding complexity through choice (and of course the implication that it could become a 'lower tax' choice).

1.44 Bearing in mind that tax reductions are not the main driver of incorporation for most small companies, there is a significant benefit to some company owners of a simpler look-through taxation system that ultimately puts them in the simpler sole trader tax system. Thus simplification was the main reason for people supporting a look-through approach. There was also strong support for look-through, because it ensured that all small businesses would pay the same effective rate of tax, whether incorporated or not. This was also noted in the Mirrlees review, which concluded "the UK experience lends strong support to the argument that the tax system should not set to favour one legal form over another".

1.45 The main argument against look-through was that it would subject profits retained by the company to full income tax/NICs and therefore reduce the funds available for investment and growth. For this reason, a look-through based system would not be suitable for growing companies. However, for the large proportion of small companies that do not grow, and have no intention of growing, a look-through system could work. These companies also tend to withdraw all or most profits and the difference in tax paid will be significantly reduced once the dividend tax is introduced in April 2016.

Chart 1.C: Funds retained by business owners under corporation and self-employed/look-through tax treatments (from April 2016)

	£10,000	£25,000	£50,000	£100,000
Company	£9,612	£21,191	£39,691	£67,038
Self-employed	£9,679	£20,529	£37,369	£66,369

Source: OTS Calculation

* Assumes all profits are extracted from the business after salaries of £8060 (the NICs threshold)

1.46 In principle, the OTS can see that a look-through system offers scope for simplification. Look-through would not work for everyone and we would imagine that growth companies, who would not be interested, would be more likely to seek advice on considering their options and take a conscious decision to opt out. However, we do not underestimate the difficulties in defining the eligibility for such a system and are concerned that the result could push small companies into needing further professional advice on how to proceed.

1.47 **Aside from the tension of potential simplification benefits of look-through versus the complexity of adding a choice of system, there are wider considerations around tax motivated incorporation and falling corporation tax rates. The OTS believes there is sufficient merit in a look-through basis for a target range of companies to warrant developing an outline of such a system in sufficient detail to generate proper debate. We recommend that the OTS undertakes this task. The basis would be a look-through system for a target range of companies that:**

- **Do not intend to increase in size;**
- **Are effectively one-person businesses;**
- **Distribute all (or almost all) their profits; and**
- **Have few assets or need for investment funds.**

1.48 Specific issues to address include:

- Defining and managing the target range of companies;
- Whether this would be a compulsory, default with opt-out or optional system;
- Transitional considerations, including the whole impact of the potential change in system of taxation for the target companies.

Lessons from international regimes: consolidated tax

1.49 We have also considered alternative approaches to simplification including a flat rate corporate tax scheme based on the existing VAT flat rate scheme and a distributed profits tax. We did not feel that these schemes provided sufficient simplification benefit. While look-through moved someone from one existing tax treatment to another (which they would already be dealing with in their personal affairs), the other alternatives introduced an altogether new tax treatment that further complicated the tax landscape. Our findings on each of these are covered in the *Structure of Company Taxation* chapter.

1.50 However, we have seen evidence of effective consolidated tax systems in other countries. This allows companies to pay the equivalent of income tax, VAT, corporation tax and other levies in one simple 'consolidated' tax. This goes further than the alternative routes mentioned in the previous paragraph; replicating the effect off making one payment to cover many taxes could be a useful simplification.

1.51 While such a system could achieve a significant level of simplicity, the experience of other countries demonstrates that there are a lot of factors to take into account, not least whether there should be a simple, pragmatic system or one that offers a wider range of rates which may then be complex. It is also an idea that has been considered in the past in the UK to some extent. With the introduction of quarterly reporting under Making Tax Digital, such a system could prove popular as it would be in many ways a logical extension of the processes envisaged. However, given the pressures and amount of change with MTD, the consolidated tax idea is probably something to consider once MTD has settled down. Accordingly, **we recommend the**

study of a consolidated tax model as part of a longer term strategy for genuine tax simplification for micro companies (and also other micro businesses).

1.52 Based on our findings, we recommend the following attributes should be considered:

- Turnover as a basis for the tax, a figure that all companies should quickly be able to assess
- A cash basis i.e. tax is only payable on receipts so micro companies will only ever have to pay tax once they've received the income that drives the tax liability
- A mechanism to take account of the broad range of businesses that may opt to use such a system and their cost base
- Different tax rates or fixed deductions that could be used to take account of different types of businesses
- Whether the consolidated tax could replace multiple taxes including: corporate tax; PAYE and NICs on salaries payable to individual business owners, where applicable; and personal income tax on distributed profits. Consideration should also be given as to whether it could also cover business rates and VAT
- A turnover threshold to assess eligibility for the system
- A steady roll out of the scheme, for example, first offering it on a voluntary basis to non-employing companies
- Whether such a system would offer genuine simplification, bearing in mind the possible need for businesses to take advice over entry to the system

Tax administration

1.53 It is easy to be drawn into discussions solely around tax policy when thinking about simplifying the tax system, and long-term simplification often requires a change to tax policy. Yet it is the administration of a tax system that directly impacts businesses. So it should come as no surprise that we received many examples of administrative complications and suggestions for how these could be resolved.

1.54 Small company owners raised a number of specific administration issues that could be addressed in order to simplify their engagement with the tax system. All of which are covered in further detail in the *Administrative aspects* and *Lifecycle of a Small Company* chapters. Together they could make a useful contribution towards HMRCs £400 million administration cost reduction target. These are not easy issues to solve and, in unravelling them, losers as well as winners may be created. However, we believe that the overall gain in administrative savings (for business and potentially also for government) will outweigh the costs. In particular we would recommend:

- Seeking to enable taxpayers to align filing and payment dates across government departments wherever possible, e.g. VAT and PAYE, and companies' statutory accounts, annual returns and payment of corporation tax (CT)
- Improving the VATMOSS system that seeks to simplify EU cross border VAT issues
- Evaluating the feasibility of the establishment of an advance-clearance facility for VAT

- Raising awareness of the VAT flat-rate and other simplifying schemes among businesses
- Simplifying expenses claims for small companies by, for example, introducing more flat rate allowances such as those discussed in the *Administrative aspects* chapter

1.55 There are also a number of smaller issues raised during our review. We do not presume that these are all the issues that could be addressed but our researches have ensured that we have captured most issues. These provide relatively quick fixes that could reduce complication for small company owners. These include (fuller details are in the *Administrative aspects* and *Lifecycle* chapters) :

- Providing more HMRC support outside of "working hours", recognising that small company owners are typically engaged in running their companies during working hours and deal with tax affairs during evenings and weekends;
- Enable businesses to discuss issues that cross multiple tax heads of duty issues in one phone call to HMRC; to complement this, consider also more specialist heads of duty lines for agents;
- A streamlined one-stop-shop approach. Whether registering with Companies House and HMRC in one form (rather than two forms available through the same portal); or just having to provide information to government once, with different departments able to share information between themselves;
- HMRC to engage with those involved in making research and development (R&D) claims on behalf of small companies in order to establish whether its revised case studies and guidance is meeting the objectives set in the OTS UK Competitiveness Report and to establish a structured on-line claims process;
- HMRC should seek to make settlement of income tax/PAYE and NIC more customer-focussed by allowing payment more in line with employers' systems;
- HMRC's existing work on i-forms needs to be taken forward in a way that enables taxpayers to use the forms flexibly;
- No longer requiring small companies to file nil annual tax returns in respect of enveloped dwellings, perhaps via a periodically renewable dispensation process;
- Allowing representing agents to access Companies House and HMRC joint statutory accounts and tax return filing software again;
- HMRC and Companies House to review the current working of their joint filing software to reduce the requirement for its users to enter data twice, including when a company is dissolved;
- Providing a unique identifier code for all small companies capable of being recognised across all taxes and also by Companies House;
- Using prompts such as pop up boxes to provide guidance during incorporation and registration processes to prevent mistakes that can cause much greater complications further down the line.

1.56 We think there is a need for a mechanism to ensure that regulatory requirements for small companies are harmonised across government and that no new divergences are introduced. This could be though a cross-government working party, paralleling the one flowing from our Employment Status project. The likely departments to be involved are HMRC, HMT, the Department for Business, Innovation and Skills (BIS) and Companies House. Or it may be that the coordination needed may be achieved without a formal working party. HMRC could logically take the lead with the Administrative Burdens Advisory Board (ABAB) providing challenge.

Improving relations with HMRC

1.57 As found in its own research report, there remains a strong and consistent underlying fear of HMRC among small companies, even among those who acknowledged that in reality, they actually had little to fear from "the tax man". There was a strong and almost unanimous feeling among the small company owners we spoke with that HMRC treated them as potential tax evaders rather than supporting them to make correct tax returns.[15] For example, strongly worded penalty letters sent to companies for making payments a day or two late, while HMRC had been very late to address some of its own mistakes at cost to the business. HMRC officials have acknowledged this issue, and are aware that some members of the small company community simply refuse to engage with them. The dangers of this should not be overlooked.

1.58 HMRC also relies heavily on networks of accountants and tax advisers to communicate with small companies. This could cause potential conflicts of interest, especially with moves to simplify the tax system that may reduce the reliance on advisers. We were told by many, including advisers, that HMRC should seek to work more proactively through representative bodies, business groups, charitable support networks and chambers of commerce to provide advice and communication to small company owners. The Department of Business, Skills and Innovation's *Great* campaign was mentioned on more than one occasion as a good example of government establishing networks for proactive engagement with business owners.

1.59 Respondents also gave examples of useful measures taken by HMRC, praising the agent dedicated line as a beacon of good performance and calling for similar lines to be set up for VAT, PAYE and corporation tax.

1.60 There were several complaints about phone waiting times. Some also acknowledged that significant resource was being invested in this area and greater reliance on online support was a necessary cost reduction measure.

1.61 It is clear that while HMRC has implemented some well received measures it also continues to have something of an image problem. The **OTS will conduct a listening exercise alongside its future reviews to present actions that can be taken forward to improve HMRC's image and relationship with small companies.** We do not expect this to be easy or an issue that can be addressed in the short term.

Revisiting disincorporation relief

1.62 OTS's Small Business Tax Final Report on Disincorporation Relief, published February 2012, suggested that a small but significant number of small companies would like to disincorporate while continuing to run the business. These companies had found that the additional

[15] We are of course well aware of the figures in HMRC's tax gap analysis that shows that small businesses contribute a significant proportion of the tax gap. Many of the businesses we spoke to understand the issue this creates though naturally they feel that not all small businesses should be tarred with the same brush.

administration burdens from incorporating outweighed any advantages they received. However a significant tax penalty applied to dis-incorporating.

1.63 The government introduced a five-year tax relief to allow trading companies to dis-incorporate. However, fewer than 50 companies have taken up disincorporation relief to date. Small companies and advisers we spoke to suggest that the low take up rate is due to the low qualifying limit of assets not exceeding £100,000. This rules out companies that own even modest amounts of land or properties, or have accumulated goodwill. It is also a 'one sided' relief, lacking the shareholder relief that the OTS proposed.

1.64 The uptake of any of the recommendations proposed in this report and the new dividend tax rules due to be introduced in April 2016 are likely to increase the number of companies seeking to dis-incorporate. An extension of disincorporation relief will allow companies to transfer to a legal status that allows them to simplify their tax affairs without suffering a significant tax penalty at the point of disincorporation.

1.65 We are aware that a review of disincorporation is likely in 2018. It may be sensible to bring this forward and, inter alia, consider whether:

- the £100,000 limit is working in practice or should be raised;
- the shareholder relief contained in the OTS's original recommendations should be introduced; and
- the relief should be extended to apply to transfers from a limited company to an LLP.

Making Tax Digital

1.66 The Autumn Statement 2015 set out HMRC's bold vision to digitally transform the UK tax system by 2020. This announcement is of such significance that to ignore the design and implementation of Making Tax Digital (MTD) in our report would, in our view, be an opportunity lost in respect to:

a) Working with HMRC to avoid areas of complexity in the current system just being replicated in the new digital system; and

b) Assisting HMRC in minimising any unintentional design of new complexity into MTD.

1.67 At the launch of MTD, HMRC announced that it would be consulting on the design and implementation of MTD from early in 2016 (midway during our review). The timing of this means most of the observations garnered during the evidence gathering stage of our current review are based on individuals' assumptions made about MTD in the absence of detailed information. It also means not all those we consult will have had the opportunity to comment on MTD.

1.68 It is not the purpose of this report to carry out an evaluation of MTD. A fuller digest of opinions is provided in the *Administrative aspects* chapter. Respondents were generally positive about the principle of MTD, appreciated HMRC's open and collaborative approach to the development of the proposals, and the opportunities created for administrative simplification as key benefits.

1.69 However, a number of concerns were raised around the lack of digital infrastructure in rural areas and reliance on third party applications. There was also confusion about the amount of information that might be required on a quarterly basis and whether this would properly take account of, for example, seasonal businesses and those with large amounts of stock. There is a

genuine concern that while there is great scope for simplification, MTD could end up significantly increasing reporting requirements and costs for small companies. HMRC's communication with small companies to date has not cleared up this confusion.

1.70 HMRC must take care not to underestimate the scale of support required from businesses that are not able or willing to engage with MTD. Failure to properly support this population may further widen the gap between those who do and those who do not actively engage with the tax system as a whole.

1.71 We are sure that HMRC will have heard all the messages that we have heard and more. The key issues, apart from the digital structure itself, seem to revolve around:

- the amount of information required;
- how easily it will be uploaded from accounting systems;
- whether this will contribute to closing the tax gap, as in many cases businesses will start to claim expenses they would otherwise have missed (which of course could be a selling point for the changes);
- the implications for tax payments;
- mandation, with the implication that penalties will be levied for non-compliance
- agent involvement;
- whether benefits will materialise, including the elimination of the tax return;
- Whether HMRC can deliver the necessary IT aspects, including availability of Apps.

1.72 Overall the OTS very much supports the direction of MTD. It offers scope for simplification and the digital direction is something we have always endorsed and encouraged. But ensuring it does reduce burdens on business is critical and **as already noted we recommend that the OTS is formally involved in MTD's development to ensure simplification issues are considered.**

Summary of recommendations

Main Recommendations	Chapter
OTS develops an outline of a 'Sole Enterprise Personal Assets' (SEPA) vehicle to test its practicability and whether it would deliver the desired personal asset protection in practice.	2
That the possibility and practicality of a cash basis of accounting being used for the smallest companies is explored.	2
OTS develops an outline look-through system of sufficient detail to generate proper debate. The would target range of companies that: • Do not intend to increase in size; • Are effectively one-person businesses; • Distribute all (or almost all) their profits; and • Have few assets or need for investment funds. The design should be of sufficient detail to generate proper debate.	4
That government seeks to closer align taxable profit with accounting profit following the recommendations of the UK Competitiveness Report, focussing on exploring whether many of the 'sundry tax adjustments' could be eliminated. This could lead to a cash basis under MTD.	4
The study of a consolidated tax model as part of a longer term strategy for genuine tax simplification for micro companies (and also other micro businesses).	3
Seek to enable taxpayers to align filing and payment dates across government departments wherever possible, e.g. VAT and PAYE, and companies' statutory accounts, annual returns and payment of corporation tax.	5
Improving VATMOSS system that seeks to simplify EU cross border VAT issues.	4 & 5
Evaluating the feasibility of the establishment of an advance-clearance facility for VAT.	5
Improves awareness among businesses of the VAT flat-rate and other simplifying schemes.	5
Simplify expenses claims for small companies by building on the existing flat rate allowances.	5
Coordinate cross-government regulatory change. The likely departments to be involved are HMRC, HMT, BIS and Companies House and it may be that ABAB can oversee.	5 & 6
OTS will conduct a listening exercise alongside its future reviews to present actions that can be taken forward to improve HMRC's image and relationship with small companies.	1
OTS is formally involved in the development of Making Tax Digital to ensure simplification issues are considered.	4 & 5

1.73 In addition to the above main recommendations, the OTS has identified a number of more minor recommendations. Most are listed at paragraph 1.55 above as they relate to administrative aspects.

2 Legal issues and alternative structures

Introduction

2.1 The tax system treats individuals differently depending on whether they are providing their services through an unincorporated business or an incorporated company. Assessing the landscape of how services are provided by individuals through either of these entities[1] raises some challenging issues and areas for tax simplification.

2.2 The tax system is still best suited to a time where people were employees or business owners (either as self-employed or through a company) but never really moving back and forth between the two or indeed operating in both states at the same time. However, this is becoming more common place as UK PLC relies increasingly on a flexible workforce. The numbers of self-employed[2] people and individuals providing their own services through a limited company, or 'sole entities'[3] for want of a better expression, have grown exponentially in recent years and are continuing to grow.

2.3 There are many labels used to describe these individuals or sole entities – e.g. self-employed, sole trader, sole proprietor, freelancer, one-man band, personal service company, contractor, etc. – but there are no statutory definitions. Some labels refer to an individual who provides their services as a registered self-employed person, but who is often indistinguishable from another individual who operates through an incorporated entity, and this causes much confusion. Both the Employment Status Review[4] and the recently published Self-Employment Review[5], called for a single definition of 'self-employment' for tax and employment law purposes. For the purposes of this review, the different types of companies need to be distinguished between the so called 'personal service companies' or PSC and those non-employing companies that would be outside of that description.

Sole Entities

2.4 The growth in sole entities can be attributed in part to the new business models in the 'sharing economy'[6]. Platforms provided by the likes of Uber, Airbnb, and TaskRabbit for example, are set to grow from a current estimated value of £15bn to £335bn by 2025.[7] There is also a growth in e-ployment or online staffing services such as Elance, Freelancer.com, oDesk and People per Hour, where individuals supply services to businesses, perhaps when in the past an employee would have done so. The sharing economy "has the potential to turn UK public

[1] These are the two main entities that are used, but entities may also include a limited liability partnership.
[2] There are various different ways of describing the self-employed such as sole trader, sole proprietor, etc., but there is no legal definition.
[3] A 'sole entity' can be described as any individual who is providing their own services either as self-employed, through a limited company or possibly through a limited liability partnership, but works on their own and does not employ anyone or plan to in the future.
[4] Published by the OTS in March 2015
[5] An independent report carried out by Julie Deane OBE, founder of the Cambridge Satchel Company.
[6] Also known as "on-demand" or the gig economy.
[7] PWC "The Sharing Economy" 2014 – this figure represents the revenue from the five key sectors.

into a nation of micro-entrepreneurs"[8], so the need to create a simplified tax system is even more pressing.

2.5 Since 2000, the growth in the UK private sector business population has been mainly due to the increasing numbers of non-employing businesses, which accounted for 90% of the total growth[9]. It was estimated at the beginning of 2015 that there were 4.1 million non-employing businesses[10], 723,000 of these were companies[11] and 3.1 million were sole traders. The number of non-employing businesses increased by 112,000 or 3% and non-employing businesses accounted for 76% of the overall increase to 5.4 million UK private sector businesses since 2014.

2.6 For those who choose to incorporate, the net result can be that they reduce the overall amount of tax that they pay. However, what is clear is that the types of sole entities are diverse and the manner in which they provide their services are not all the same. So, it may not be appropriate to treat all sole entities in the same way, if we are to solve these complex issues.

2.7 Against that background, simplification could be approached from a different angle, i.e. identify the multiple types of sole entity, and then type-specific issues can be solved with a more targeted approach. By way of an example, the evidence shows that one of the main reasons for a self-employed individual to incorporate their business is for limited liability. A sensible solution might be to provide that person with the limited liability that they require, but in such a way that they can remain as a self-employed individual. This type-specific targeted approach may bring simplification by simplifying the interaction with the tax system for different populations, rather than using a 'one size fits all' approach.

2.8 However, full simplification in this area would require a review of the needs of this flexible workforce as a whole, including the part that the engager plays, not just those that are companies and fall within the scope of this review. This will involve taking into account the provision of services by individuals who are not employed, spanning across the self-employed, home workers, agency workers, umbrella workers, PSCs, one-man limited companies. These individuals may be full time, second jobbers, working through an agency or with multiple clients.

Motivations for incorporation

2.9 There are several motivations for incorporation including: limited liability, tax, ability to get work, credit rating, prestige, etc. and it is important to understand why a particular individual would be motivated to choose incorporation in preference to providing their services as a self-employed sole trader.

Taxation

2.10 Once incorporated, the individual continues to conduct the same business, but now with a significantly different tax treatment that often results in a lower tax charge following analysis and planning. This could be seen as creating an inequity in the tax system generally. The

[8] *Unlocking the Sharing Economy*- An Independent review by Debbie Wosskow for BIS – November 2014

[9] Department for Business, Innovation and Skills (BIS) Business Population Estimates for the UK and Regions (BPE) 2015 – URN 15/92

[10] "non-employing" or 'with no employees' comprises sole proprietorships and companies comprising only an employee director. Although, it is not stated whether this "non-employing" includes a spouse, in an admin role, for example.

[11] According to the BIS BPE all companies were 'actively' trading and excluded not-for-profit.

dividend tax, however, will reduce the difference between the tax paid as a self-employed sole trader and as an incorporated individual.

Table 2.A: The difference between self-employed and limited company earnings if the limited company pays a minimum salary and remaining profit extracted as dividends

2016/17	**Self-employed**	**Extraction**	**Ltd Co.***	**Extraction**
Profits	**25,000**	**25,000**	**25,000**	
Salary = NI primary threshold			- 8,060**	8,060
Profits after salary				16,940
Corporation tax @ 20%			- 3,388	
Dividend = distributable profit			13,552	13,552
Less: Personal allowance	- 11,000		- 2,940	
Taxable	14,000		10,612	
Income tax @ 20%		- 2,800		
Dividend tax 5,000 @ 0%				0
Dividend tax 5,612 @ 7.5%				-421
Class 2 NIC		- 146		
Class 4 NIC profit @9%	16,940	- 1,525		--------
Extraction		**20,529**		**21,191**

Source: OTS figures

*Assumes the most tax efficient method of extracting all profits from the company while still registering for national insurance.
**The structure of National Insurance allows a company owner to register for state pension payments at the lower earnings limit (£5,824), while not actually making any National Insurance Contributions until the primary earnings threshold (£8,060).

2.11 The differing tax results between incorporated and unincorporated are an area of considerable study and debate, including at government policy level. Having noted and illustrated the issue, we were not take it further in this chapter but will return to the taxation issues in later chapters.

Unlimited liability

2.12 A self-employed sole trader trades with unlimited liability, meaning that personal assets, including their home, are at risk. An obvious solution to this is to seek limited liability and, currently, the only way to do that is by incorporating as a limited liability company[12].

2.13 An HMRC commissioned Ipsos Mori study[13] found the most common reason cited by 'nano'[14] and 'micro'[15] businesses for incorporating was for the protection offered by limited liability (28%). This figure rose to 78% of respondents who were prompted for reasons to

[12] The limited liability partnership route requires two or more members so in theory is not available to a sole trader but we illustrate later in this chapter how a single member LLP can in effect be established.
[13] HMRC Research Paper 317 "Reasons behind incorporation" published in June 2014
[14] The term 'nano' does not have a legal definition and was not defined in this HMRC Research Paper, but it is assumed to mean a non-employing company or a company with zero employees other than the working director.
[15] A 'micro' company is defined in full below, but has 10 or fewer employees.

incorporate. The next most commonly cited unprompted reason for incorporating was tax and national insurance savings (19% cited it then), though it was the fourth most widely cited reason after prompting (61%).

2.14 The population of non-employing sole traders at the beginning of 2015 was 3.1 million, by far the most common form of business. Furthermore, one in five of the respondents to an HMRC report[16] were self-employed in the same business prior to incorporation. If the predominant reason for incorporation is for limited liability, then perhaps providing the self-employed with some form of limited liability would negate the need for incorporation and the complex tax and accounting system it entails.

Agency tax legislation

2.15 Incorporation of some businesses is arguably motivated in part[17] by the so-called 'agency tax legislation', in its current form in s44 Income Tax (Earnings and Pensions) Act 2003 (ITEPA). The incorporation is seen to be as a consequence of the legislative provisions affecting workers supplied by agencies, where the agencies began requiring individuals to incorporate in order that the agency would not be responsible for PAYE. In addition, although not motivated by s.44 ITEPA per se, because of the desire of the engager to avoid Employers' National Insurance contributions; employment rights (although this is often an erroneous assumption[18]); and, in some situations, the national minimum wage legislation.[19] It is now commonplace that neither the agency nor the engager will enter into a contract with individuals unless they have incorporated.[20]

2.16 In 2015, s.44 ITEPA was amended[21] such that an agency has to prove that any self-employed worker they place with a client is genuinely self-employed. To do this it will have to be proved that the worker is not under the direction, supervision and control of anyone. If this cannot be proved, then the agency will have to pay PAYE on the fees paid to a self-employed individual. The presumption is that there is supervision, direction and control, unless it is proven otherwise. This amendment may increase incorporations.

2.17 There has been further legislation that may also have affected incorporation decisions. A full list has been provided in Annex B. Whether the legislation has had the desired effect is uncertain, but what is clear is that there were unintended consequences that have manufactured an industry of limited liabilities companies that do not fit within the current system and which appears to create a distortion.

2.18 The agency tax legislation has been very effective in that there are far fewer self-employed agency workers, but now far more incorporated individuals. An 'agency' worker is now either employed by the agency as a 'temp', or provides their services through an 'umbrella company', or more usually uses a personal service company. It could be said that the reason that the legislation is very effective is because both the agency and the client can take steps to mitigate

[16] ibid
[17] It is not believed the this is the entire motivation by these 'agency motivated incorporations' as other events in the contractual chain are motivated by the engager not wanting to be exposed, for example, to a claim for employment rights.
[18] It is a common assumption, however, that the engager is protected from an employment rights claim if the worker is incorporated but, as it was shown in *Catamaran Cruisers Ltd v. Williams* [1994] IRLR 384 EAT, this may not always be the case.
[19] The National Minimum Wage legislation does not apply to directors of a limited company, *per se*.
[20] Evidence was taken from the House of Lords Select Committee on Personal Service Companies in 2013.
[21] s.16 Finance Act 2014 – amends Chapter 7 of Part 2 of s.44 – 47 Income Tax (Earnings and Pensions) Act 2003.

their position and avoid a tax liability in its entirety, by forcing incorporation. The individual will not receive a contract unless they have incorporated.

Simplified accounting procedures

2.19 During our evidence gathering, the OTS considered whether a simplified business form could have limited liability and a simplified accounting procedure, potentially on a 'cash basis'.[22] It was very quickly apparent that utilising the cash basis in a new type of company with limited liability would require an exemption from the EU Accounting Directive[23] (the Directive).

2.20 The national law on accounting procedures has to be transposed from the Directive and under the Directive, certain limited liability entities have to use the accruals basis[24] for accounting. This provides certain financial information that protects the shareholders, members and third parties where the entity has limited liability.[25] In the event that the UK decided to provide a new type of limited liability company, this would also have to be reported to the EU Commission for consideration.[26]

2.21 The Directive has recently provided for a 'micro entities regime' of simplified accounting procedures, which some have called "Cash+"[27] accounting. The Financial Reporting Council (FRC) in the UK has also just published the financial reporting standards applicable to the micro-entities regime.

Micro-entities regime

2.22 In 2013, the Directive was amended partially to provide for the exemptions for "micro-undertakings"[28], the objective being to reduce the administrative burdens for these companies. This Directive was transposed into national law as the Small Companies (Micro-Entities' Accounts) Regulations 2013[29]. In July 2015, the FRC published FRS 105; a new standard applicable to the Micro-entities regime. FRS 105 became available for use by micro-entities choosing to adopt this simplified regime from 1 January 2016.

2.23 A company qualifies[30] for the micro-entity regime in a financial year if it satisfies two or more of the following:

Turnover	not more than £632,000
Balance sheet total	not more than £316,000
Number of employees	not more than 10

2.24 There are some companies that are excluded[31] from using the micro entities regime including LLPs, financial institutions and charities, although BIS is currently consulting on extending the regime to LLPs.

[22] Introduced in 2013, as recommended by the OTS, cash basis is for sole traders and partnerships with an annual sales turnover of less than the VAT Threshold currently £82,000 (2015/16).
[23] EU Accounting Directive 2013/34/EU
[24] As part of 'Generally Accepted Accounting Principles' or GAAP
[25] Para 3. pre-amble EU Accounting Directive 2013/34/EU
[26] Article 1 – EU Accounting Directive 2013/34/EU
[27] Fédération des Experts comptables Européens (FEE) or the Federation of European Accountants
[28] EU Accounting Directive, Chapter 9, Article 36 – Exemptions for micro-undertakings
[29] S.I. 2013 No. 3008
[30] s.384A Companies Act 2006
[31] S.384B Companies Act 2006

2.25 The amount of information included in the micro-entity accounts is significantly less than that included in small company accounts, but there is also less flexibility. The micro entity accounts prepared in accordance with the micro entities regime will also represent accounts prepared under GAAP.

2.26 FRS 105 has only just been introduced at the time of writing, so it is too early to tell whether it will have a significant impact, but feedback suggests that it may not have much of an impact on the micro entity itself. It is unlikely that micro-entities will be any more comfortable in doing their own accounts and, in any case, the majority of micro-entities use an accountant to produce their accounts. According to commentators, it is also unlikely to reduce the amount of time taken to produce the accounts and not, therefore, reduce the fees to the micro-entity. FRS 105 exhausts all the exemptions allowed by the Directive but any simplification is unlikely to benefit the company. Meaningful simplification will require going further and seeking further exemptions from the Directive.

2.27 There is, however, a provision in the Directive[32] for the Commission to report back to the European Parliament by 20 July 2018. The Commission is to report back on the situation of micro entities taking into account, in particular, the situation at national level regarding the number of undertakings covered by the size criteria, and the reduction of administrative burdens resulting from the exemptions from the publication requirement.

Limited Liability

2.28 Traditionally, a sole trader has always traded with unlimited liability. Limited liability is the preserve of the limited liability company or the more recent LLP. Many sole traders choose to incorporate because of the protection limited liability affords[33].

2.29 There is another distinct difference between a sole trader and an individual trading as a limited company as a limited company also has a separate legal identity or corporate personality, distinct from that of its owners. Limited liability and the doctrine of corporate personality are not one and the same. The transferability of shares permits a degree of business continuity for incorporated businesses which is not possible in other enterprises, especially that of a sole trader, where the business dies with the sole trader.

2.30 It is important to consider separate legal identity as distinct from limited liability, because it may be necessary for any alternative business structure to have both. The engager or end user, especially under the agency tax legislation, may not want to engage with the individual unless there is also a separate legal identity.

Alternative business structures

2.31 We now consider whether it is possible to simplify tax for two types of existing nano company: the self-employed sole trader needing to protect their personal assets as an alternative to incorporating; and the non-employing company needing simpler tax. Alternative potential business structures to simplify tax for these businesses are summarised below.

[32] EU Accounting Directive, Chapter 9, Article 36 (9)
[33] As many observe, the liability protection achieved in practice is often significantly eroded because of personal guarantees given by the proprietor, usually for bank debt.

Table 2.B: Alternative business structures suggested as a result of internal and external research and feedback

Type	Tax	Incorporated	Description	Acct basis[34]
Self-employed with Protected Assets (SEPA)	IT / Class 4 NICs	No	Self-employed with protected personal assets but not separate legal identity (SLI)	Cash basis
Self-employed Business (SEB)	IT / Class 4 NICs	No	Self-employed with limited liability (LL) and SLI	Cash basis
Limited Liability Business (LLB)	IT / Class 4 NICs or other treatment	Yes	New entity - Restricted company with LL and SLI – transparent tax treatment	Accruals
Freelancer Limited Company (FLC)	IT / CT and Dividends	Yes	Restricted company with LL and SLI – based on corporation tax	Accruals
Personal Service Company (PSC)	IT / CT and dividends	Yes	Restricted company with LL and SLI – based on corporation tax	Accruals
Sole member LLP	IT / Class 4 NICs	No	Limited liability partnership with a single member	Accruals / Cash basis

Source: OTS classification

Unincorporated Self-employed

2.32 It may be possible to provide limited liability without the sole trader having to incorporate as is the case in other jurisdictions, for example France and Chile.

Box 2.A: Business incorporations

Statistics show that 21 per cent of businesses that incorporated were previously self-employed in the same business before incorporation.

Source: Ipsos MORI "Reasons behind incorporation" – HMRC Research Report 317

2.33 In January 2011, the French government introduced a new entity called the *Entreprise Individuel à Responsabilité Limitée* or EIRL. This effectively gives the sole trader limited liability without having to incorporate. The creation of the EIRL protects the sole trader's personal assets including their home and it requires some formalities including the publishing of the statement of assignment of the protected assets and a declaration of business assets known as the *patrimoine d'affectation.*

[34] The accounting basis is dependent on the EU Accounting Directive, as previously discussed.

2.34 The threshold in 2015 for the valuation of the estate was €30,000; over that threshold it is necessary to have an expert, such as an accountant or notary, provide an official assessment of the value.

2.35 In Chile, there is also an EIRL or *Empresa individual de responsabilidad limitada*. This EIRL is a legal entity of a commercial nature with assets distinct from those of its owner. The assets are limited to the amount specified in the deeds and the owner is liable only with personal goods up to the capital contributed to the company, although the company is liable for all its business assets.

Sole enterprise with protected assets (SEPA)

2.36 Here, the self-employed individual would not have a separate legal identity, but there would be a provision for protecting the assets of the individual. These assets could include the individual's home, any non-business vehicles and any other substantial assets. The tax treatment could continue to be as a self-employed sole trader under the existing system although equally another tax treatment could be applied[35]. The accounting procedures could be on a cash basis.[36]

2.37 There are a number of formalities that would need to be considered, for example:

- A registration process;
- The business must have its own bank account;
- Annual accounts must be submitted, meaning the trading records would be public;
- Whether accounting can be on a cash basis;
- Any significant change in personal assets must be notified each year, including depreciation of assets; and
- The business must be labelled as a 'SEPA' in its trading name.

2.38 There will be some costs in setting up, depending on the value of the personal assets and whether an official valuation is needed. Existing businesses would probably get a declaration from their clients that they have no objection to the protection being put in place. If the sole trader has incorporated their business and wants to move back to the SEPA model, disincorporation relief[37] could be utilised.

2.39 Although this will provide a level of protection, lenders would still be entitled to ask for a personal guarantee against any business loan, which would lessen the impact of the protection, but currently this often happens with a limited company.

2.40 A caveat may be needed if the sole trader works from home. The new structure would be based on the declaration of business assets, which are then the only assets at risk against creditors. It may be difficult to separate the business from the personal assets, in terms of protecting the home, unless there was a designated working area, for example.

[35] The *International* chapter recommends a study of "consolidated tax".
[36] The position under the EU Accounting Directive is not clear with regards to whether SEPA would have to use accruals accounting as it is not strictly limited liability but protected assets. The SEPA model would also have to be assessed for compliance with any other legislation, including company law provisions, which may or may not be applicable.
[37] Disincorporation Relief is discussed in the *Structure of Company Taxation* chapter.

2.41 It may also be worth considering an independent declaration of assignment of property (in France this is the *d'insaisissabilité*). This would protect bricks and mortar property only and not other personal assets and the valuation would need to be completed by a professional. This would be the simplest form of protecting the assets of a sole trader. As with a director of a limited company, the sole trader will still be liable personally if they are found guilty of fraud or other serious failures in their business responsibilities.

2.42 The SEPA model relies on its simplicity, as such it will need to be fully assessed as to whether it can provide a simple form of protecting assets, a simple tax treatment and cash basis accounting. In practical terms, it will also need to be accepted by clients or customers and banks as a legitimate way of doing business. Most importantly, the model will need to provide an effective simplification in the system overall. **The SEPA model looks promising but we recommend that the OTS develops a proper outline of such a vehicle (a 'Sole Enterprise Personal Assets' or SEPA) to test its practicability and whether it would deliver the desired personal asset protection in practice.**

Sole enterprise business (SEB)

2.43 This would be a business structure similar to the SEPA model and can be considered as part of OTS's recommended vehicle development, but including provision to give the SEB separate legal identity. This will be of use in certain industries where the SEB is using an agency, the business would be unlikely to get work from the client or end user without having separate legal identity. Establishing a separate legal identity for the SEB might also help provide greater certainty about the business assets available to creditors.

2.44 The SEB would be taxed on a self-employed basis and similar framework conditions to a SEPA would apply.

Limited liability business (LLB)

2.45 LLB would be an incorporated company, ideally with cash accounting possible, and a transparent tax treatment. Like SEPA, a simplification for the smallest businesses who want limited liability, but don't want the complication of accruals accounting procedures and corporate tax treatment. Effectively being self-employed but incorporated with limited liability, it would therefore be more formal than a SEB.

2.46 Any new structure would have to be simple enough that the owner would be able to do their own accounts and, in having the option of not employing an accountant, would make an immediate saving[38]. As this model provides limited liability, an exemption from the EU Accounting Directive would be required.

2.47 LLB could provide a new simplified entity for the self-employed, to give the benefit of limited liability and a separate legal identity. An important issue is whether cash accounting could be used for this or other micro companies. **Therefore we recommend that the possibility and practicality of a cash basis of accounting being used for the smallest companies is explored. The OTS would be pleased to work with BIS, professional and trade bodies on this.**

[38] According to the HMRC Research Report 375 – Understanding Tax Administration for Businesses - the average micro-business pays their accountant in the region of £1,853 per annum

Restricted limited liability company & personal service companies

2.48 Another option for establishing a different legal entity could be the adaptation of the standard limited company for the specific purposes such as that of a personal service company (PSC). In 2012-13 there were estimated to be 265,000[39] personal service companies; on those figures and with steady growth the figure now could be closer to 300,000.

2.49 A PSC has no statutory or legal definition and is not precisely identifiable in the data available. The government has estimated the number of PSCs using a proxy, as a result the figure is subject to a degree of uncertainty. So, it may be useful to refer to the definition provided by the House of Lords Select Committee in their Report on Personal Service Companies in 2014:

> **Box 2.B: Personal service company definition**
>
> The term 'personal service company' is not defined in law. It is understood generally to mean a limited company, the sole or main shareholder of which is also its director, who, instead of working directly for clients, or taking up employment with other businesses, operates through his company. The company contracts with clients, either directly or through an agency, to supply the services of its director. This is the general understanding with which we approached our work.

2.50 In considering a restricted form of limited liability company, there would be some fundamental properties to any model, which would include that:

- The company is based on the existing model of a limited liability company, with restrictions in company law;
- It would need to be an actively trading company;
- The shareholding would be restricted to one or possibly up to five;
- The accounting procedures would be on an accruals basis, albeit there could be an election under the micro-entity regime;
- The shareholders would be restricted to only one restricted limited company of this type;
- The articles of association would be adapted; and
- It would be optional by default

Freelancer limited company

2.51 One proposal is the 'Freelancer Limited Company' which is a restricted form of limited liability company. This was first recommended in The Freelancing Agenda produced by the Labour Financing & Industry Group[40].

2.52 The idea was that the 'Freelancer Limited Liability company' (FLTD) would be based on a community interest company (CIC) and would offer more certainty over status for both tax and employment purposes. No great detail was given in this paper. During the OTS's Employment

[39] This figure was taken from the HMRC Intermediaries Legislation (IR35) Discussion document – July 2015
[40] The paper was written by Philip Ross and Andrew Burke, and Philip Ross was one of the founders of the PCG (now IPSE).

Status project, we considered the FLTD concept as we looked at a possible 'Third way' (between employed and self employed statuses). We were unconvinced and our report in effect challenged its proponents to consider further various aspects of the concept. Issues we felt needed further thought included whether a new corporate vehicle was needed and whether the tax calculations for such an entity needed to be varied.

2.53 In late 2015, the Association for Independent Professionals and the Self-Employed (IPSE) released their paper on the Freelancer Limited Company (FLC). The OTS have met with IPSE and discussed the FLC idea with them and other interested parties.

2.54 The IPSE paper sets out "…the rationale for a new categorisation of companies for tax purposes that would provide a benign environment for freelancing to flourish and allow HMRC to focus its attention on higher risk and more fruitful areas." The FLC would be a normal company formed under the Companies Act 2006 but would choose to operate under particular restrictions in order to qualify for a specific tax treatment. The primary driver for IPSE is to remove the risk and uncertainty of targeted legislation. This is worthy of consideration, but it also needs to be borne in mind what the population of specific sectors is and that creating an FLC type model for a small population may not be a simplification. The restricted limited company model could, however, appeal to a wider population of non-employing companies.

2.55 In the IPSE model the company would be restricted to having a single shareholder and that would be limited to the individual contractor themselves. In tax terms this would prevent income splitting under s.619 ITTOIA 2005, which would prevent some tax leakage.

2.56 Further suggested conditions relate to:

- a minimum salary requirement
- dividend frequency restriction; and
- a minimum capital requirement.

2.57 How easy this would be to create in statute and how it would work in practice, would need further research. The minimum capital requirement is a provision in other countries' versions.

2.58 The minimum salary requirement could be based on the national minimum wage but, in any case, would need to be more than the personal allowance. The distribution frequency of the dividends could be restricted to quarterly, for example, to prevent the use of weekly or monthly dividends in a remuneration strategy. Although it is worth noting what the possible effects of the proposed dividend tax might be and how this will affect any form of restricted company.

Incurrence of appropriate costs

2.59 The IPSE model includes the requirement for appropriate costs of a freelancer to be incurred, such as director's liability insurance and public liability insurance. It requires the incurring of other costs which would be incurred by a normal trading operation, in effect to prove that the FLC business is active and not simply disguised employment. The sort of costs envisaged are regulatory running costs, marketing costs and investment in equipment.

2.60 The intention is that the FLC would annually self-certify its compliance with the rules. If it cannot comply and does not self-certify, this would clearly be a flag to HMRC. It is unclear how

exactly this would work in practice, but it may be that if there was an investigation for any reason, these would be good evidence of compliance.

Tax Treatment

2.61 If a restricted form of limited liability company were established, including for an FLC, there are multiple options for tax treatment. The starting point would be that the same tax treatment as for a normal company would apply, with restrictions in the Articles of Association, but there are various other options for tax treatment, which are examined in more detail in the *Structure of company taxation* chapter.

Conclusion on restricted limited liability companies

2.62 We have considered the idea of restricted limited liability company with the variants of personal service company and FLC. In short, we do not think that introducing a variant on the standard limited company model is worthwhile in simplification terms.

2.63 We do see merit in having something of a definition of PSC and other terms, simply to ensure common understanding.

2.64 The FLC idea does have merit. However, its aim is to manage exposure to IR35, which is a subject that is outside our terms of reference. It is not, therefore appropriate for us to come to a conclusion or recommendation here as we have not formally examined the topic. We simply record here and elsewhere in this report some of the points that have arisen in our meetings and submissions.

Sole member limited liability partnership

2.65 Another possibility is a sole member LLP. With a Limited Liability Partnership (LLP), the individual partners are taxed as self-employed but have limited liability[41]. The LLP Act requires an LLP to have at least two members. The USA has a structure of a Limited Liability Corporation (LLC) which is a hybrid between a corporation and a partnership which allows for a 'single member' LLC[42].

2.66 Adapting this existing structure to provide a vehicle for an individual trader would probably be easier to deliver than creating a new entity.

2.67 The LLP is not currently governed by the EU Accounting Directive and so at present does not have to use the accruals basis of accounting. It does, however, use the accruals method under English law because it is within the Companies Act 2006 provisions for accounting procedures (Part 15 Accounts and reports).

2.68 A route to achieving a single member LLP would be for a sole trader to form a sole member limited company and then form the LLP with that company as the other partner. This route was drawn to our attention in a couple of meetings; it may not comply with the spirit of the LLP rules but it is apparently accepted in practice.

[41] Limited Liability Partnerships Act 2000 s.1 (2) "A limited liability partnership is a body corporate (with legal personality separate from that of its members) which is formed by being incorporated under this Act…"
[42] More detail on this model is in the chapter on "Lessons from other countries".

2.69 If the single member LLP (using a dormant company as the second member) is an accepted route, we think it should be publicised. This is a policy matter for others to explore but we do think the option has merit and we will take note of it in our proposed work on SEPA.

Conclusion

2.70 Any simplifications for sole entities must be future-proof. The growth in the new employment models such as in the 'sharing economy', the 'third way of work', second jobbers,[43] and the move towards more knowledge based services suggests it would be a fair conclusion that the growth in non-employing businesses will continue[44]. Whatever provisions are put in place now, however, need to be robust enough to cater for this growing population for many years to come.

2.71 These sole entities are an incredibly diverse group, covering a wide range of occupations, sectors and industries. There is clearly a demand and a desire for this flexible type of working and nearly 60% of the rise in self-employment in the last five years has come in higher skilled managerial, professional and associate professional jobs[45]. Care must be taken to understand the sectors and motivations or incorporation in each in order to appreciate how these individuals work and interact with the tax system.

2.72 On a final note, according to psychological studies into taxpayer behaviour "…the enthusiastic pursuit of taxpayers with the stick of audits and fines could backfire, creating more resistance."[46] This should be considered in regards to any future interaction with this sector. Ensuring that any engagement between government and businesses is and is seen to be helping rather than just policing.

Recommendations

- The OTS develops an outline of a 'Sole Enterprise Personal Assets' (SEPA) vehicle to test its practicability and whether it would deliver the desired personal asset protection in practice.
- That the possibility and practicality of a cash basis of accounting being used for the smallest companies is explored. The OTS would be pleased to work with BIS, professional and trade bodies on this.

[43] "Second Jobbers" are those who may be employed but have a second job that is self-employed or PSC
[44] Non-employing businesses have accounted for the majority of the population growth of 90% since 2000.
[45] Self-employment Review – An independent Report by Julie Deane OBE. – published February 2016
[46] British Psychological Society "Behaviour Change: Tax and Compliance" 2013

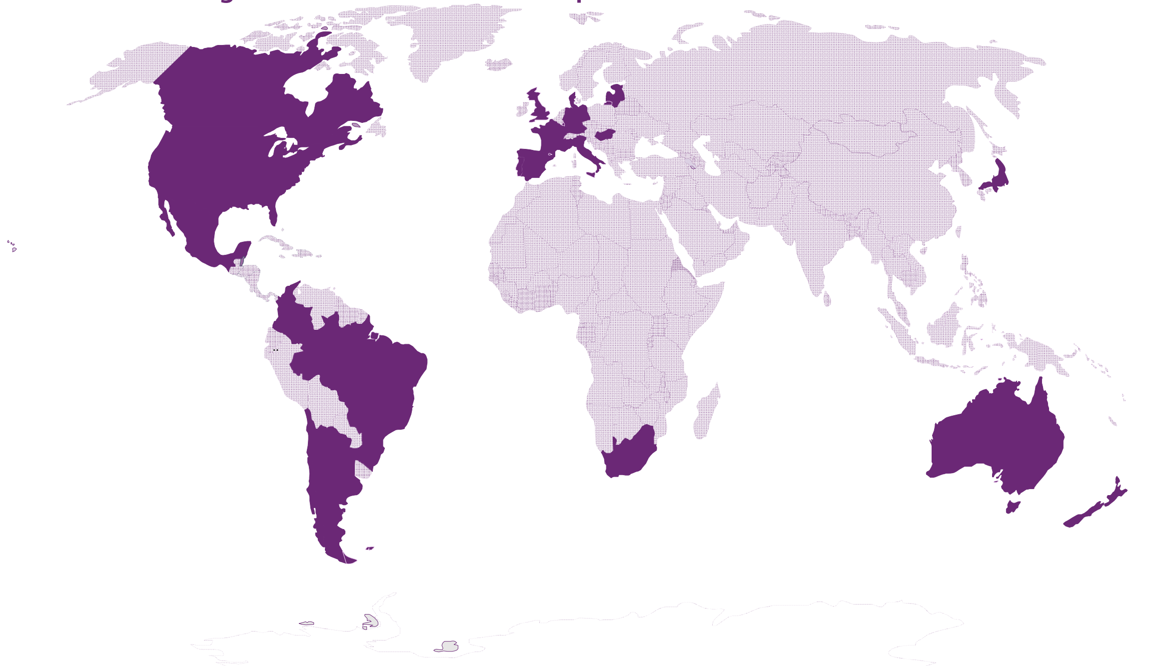
3 Lessons from other countries

3.1 The UK is not the only country looking at opportunities to simplify how micro businesses, including micro companies, are taxed. A number of other countries are doing the same, having recognised the importance of these businesses to the overall economy of a nation.

3.2 So before trying to create our own system to simplify tax for micro companies we should look to what others have done and are doing in this area to see what we can learn and whether their approach could work for the UK.

3.3 How countries define the terms small and micro and set the boundaries as to who should qualify for special regimes vary considerably, some using the EC definitions but many setting separate limits based on turnover, employee numbers, shareholder numbers and other factors.

Chart 3.A: Tax regimes considered for this report



Source: approximately 20 countries were considered (highlighted in purple on the world map above).

3.4 Many of these countries offer something different for small and/or micro companies. Some simply provide a reduced rate of corporation tax, some focus on providing specific incentives, while others offer a different way of paying tax entirely. Given our objective is simplification, it is this latter group of countries that is the focus of this chapter, as we ask “Has their system achieved a simplification in taxation for the entities it is targeting?” Our review focuses on the following eight countries (out of 20 reviewed in all; see Annex C for the detailed analyses):

- Australia
- France
- Hungary
- Latvia
- Lithuania
- New Zealand
- South Africa
- United States of America

3.5 Other countries surveyed but not analysed in depth were: Argentina, Brazil, Bulgaria, Canada, Chile, Colombia, Denmark, Germany, Italy, Japan, Portugal and Spain.

3.6 The countries considered have either been highlighted during our stakeholder meetings or identified through research as having a unique approach to how they handle the taxation of small and/or micro business. During our meetings Australia and New Zealand came up on more than one occasion as being perceived to be simpler. Can their system for taxing small companies work for us in the UK? Germany has also been cited during our meetings as having a straightforward system. However, in Germany the approach to taxing micro companies doesn't significantly differ from how all other companies are taxed. Does this suggest it's not necessary to create a system specific to micro companies provided the wider tax system is easy to navigate?

3.7 Our terms of reference identified some specific alternative mechanisms of taxation that we would consider as part of our review, including a look through basis and a turnover tax. While a number of these systems share common principles, each is tailored to fit with the unique economic and tax landscape of the particular country.

3.8 This chapter is structured to consider each principle of taxation in turn, using country case studies as examples on which to judge the pros and cons. A more detailed explanation of each system is included in Annex C1, with a list of the corporate and VAT rates in Annex C2.

Alternative business models

Limited liability business

3.9 In a number of countries, for business owners to benefit from limited liability when setting up in business, to provide protection over their personal assets, there are few other options than incorporating a company. This is particularly true for business owners embarking on a business venture on their own.

3.10 The cost of incorporation can, in some cases, make this route prohibitive, due both to the professional fees associated with the incorporation and the minimum share capital requirements of a particular country. That said, the potential barriers to incorporation do seem to be falling in many countries. For example, France previously required €37,000 minimum share capital to establish a SARL, however since 2003 this has been reduced to €1. Since 2008, for those setting up a company in Germany now have the option of a "mini GmbH" or *Unternehmergesellschaft ("UG")*. A UG can also be set up with just €1 of share capital compared to the original GmbH which requires €25,000 of share capital. While initial set up costs may be reducing and the process is becoming easier, the ongoing legal and compliance obligations of operating through a company, in general, remain more time consuming and costly than operating as a sole trader. This can include a more complex system of taxation.

United States of America

3.11 The United States of America ("US") *Limited Liability Company* or *LLC* has been existence since the early 1980's and has become a popular choice of business entity over time, typically being easy and cheap to set up (although this depends on the state in which it is set up). While the name may suggest it is an incorporated entity, it is in fact a hybrid legal entity that has

characteristics of both a corporation[1] and a partnership. Instead of shareholders it has members and the profits and losses of the business are passed to them according to their membership share. There is also the opportunity to form an LLC with a single business owner, termed a *single member LLC* or *SMLLC*.

3.12 If the LLC has only one member, it is taxed as a sole proprietorship. If the LLC has two or more members, it is usually taxed as a partnership with the taxes of the company passed through to the owner or owners on their personal tax returns. As such, it is considered a transparent entity for US tax purposes. However, an LLC is also eligible to apply to be taxed as a corporation. Usually this election is made if the tax structure would be to the advantage of the company, dependent on a number of different factors including profitability and the state tax system where it operates.

3.13 Other countries that have similar entities to the US LLC include Brazil, Chile and Colombia, however most treat them as opaque for tax purposes i.e. subject to corporation tax. Of those that we have reviewed, only in the US is there the choice as to whether to treat the LLC as transparent or opaque.

France

3.14 An individual in business in France has the option to make a *déclaration d'insaisissabilité or* declaration of unseizability. This allows the individual entrepreneur to protect his/her properties (home, second home or other real estate) not connected with the business.

3.15 Since 2011, another option has been made available, the legal status of *Enterprise individuelle à responsibilité limitée* or *EIRL*. Under this regime the individual allocates and declares a certain share of his/her assets to his/her professional activity so that in the event of insolvency or financial difficulty, creditors are limited to accessing those. We understand EIRL status has become a popular route by which to set up in business.

3.16 With the EIRL status, as with most others in France, comes flexibility about how to be taxed. The business can choose to be subject to income tax (i*mpôt sur le revenu) or* company tax *(impôt sur les societés).* Anecdotal feedback suggests that the numbers who choose to be subject to income tax is limited because the dividend taxation regime that comes with company taxation is generally considered beneficial. This is due to the potential to make reduced social security contributions through the payment of dividends. The position has however changed since 2013 and, in certain circumstances, there is now a requirement to make additional social security contributions to bring the individual's tax position in line with that of someone who is self-employed.

3.17 The establishment of EIRL status demonstrates a recognition of the importance of providing a degree of protection to individual business owners without forcing them down the route of incorporation. However, whether the flexible approach to taxation overlaying this limited liability status achieves simplicity is not clear. With choice comes a decision to be made. Cost savings and driving efficiencies will no doubt influence the decision. Therefore, in the absence of aligned income and corporate taxes to ensure the tax differential between the options is limited, the natural conclusion perhaps is to provide a single system of taxation for all, be it income tax or corporation tax.

Advantages of a "limited liability business"

[1] While in the UK, we take the term company to mean an entity established with share capital, in the US this would be classed as a corporation, distinct from a company.

- Easier to establish than incorporating a company
- Provides the benefit of limited liability without forcing individuals to establish a company
- Fewer legal and reporting obligations on an ongoing basis
- Provides the opportunity to pay a single layer of tax

Disadvantages of a "limited liability business"

- Choice of taxing options can itself add complexity

Alternative forms of taxation

Transparent tax

3.18 Under the concept of transparent taxation, the company itself is ignored (i.e. treated as transparent) and instead the company owners are subject to tax personally, based on their relative interest in the company's profits or losses. This is often termed a lookthrough basis.

United States

3.19 For those in the US who choose to set up as a corporation, there is a choice as to how they are taxed. Either then can be taxed as a regular corporation (a C corporation) or as an S corporation and apply a transparent treatment. Here, instead of paying taxes at both the company and owner level, taxes are only paid by the owners at the relevant rate of income tax based on their respective interests in the S corporation.

France

3.20 An approach similar to the US applies in France where businesses established as a limited company with a single owner, Enterprise Unipersonelle à Responsibilité Limitée or EURL, can elect to pay personal income tax or corporation tax. Private limited companies, Société à Responsibilité Limitée (SARL) which meet certain conditions can also apply this treatment. The commentary on EIRL's already highlights some of the difficulties that can arise in providing options – if there is a significant differential between the tax cost under each option tax will become a driver in the decision making process.

New Zealand

3.21 New Zealand has had the concept of a *Look Through Company* or *LTC* since 2010 (prior to this they had Loss Attributing Qualifying Companies or LAQCs which applied some similar concepts). It is estimated there are around 50,000 companies in New Zealand that have elected into the regime. The concept is as described above, all profits and losses of the company pass through to its shareholders in proportion to their interest. This is subject to certain loss limitation rules which seek to limit losses to the amount the shareholder is at risk economically. The legislation is currently under review and there is a of consultation to simplify some of the rules, for example the loss limitation provisions, as well as to ensure it applies only to those businesses it was intended to apply to.

Australia

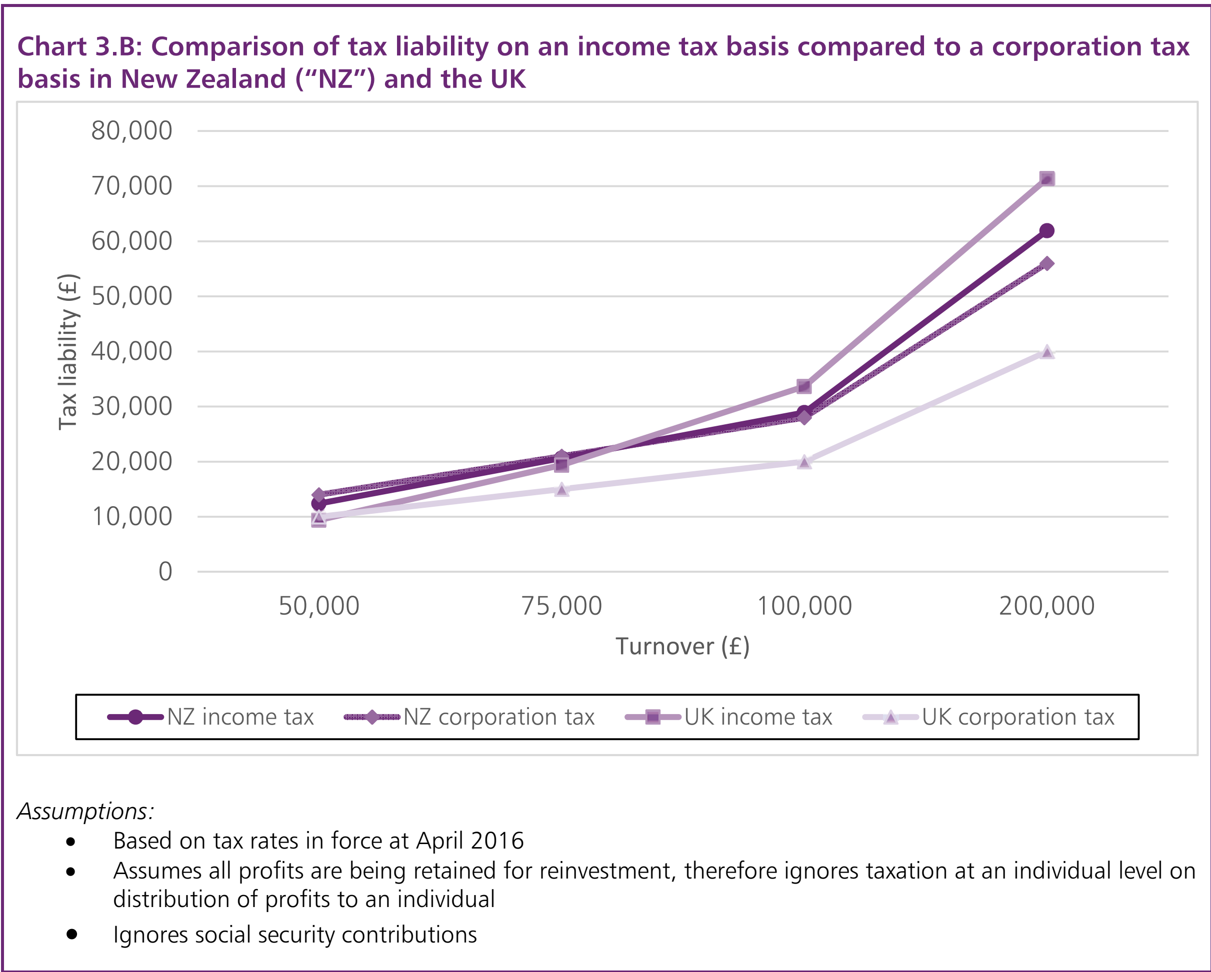
3.22 We understand that a look through system of tax has been under discussion in Australia from time to time, but so far there are no plans to implement such a scheme.

What drives the decision to opt in?

3.23 When assessing the success of an optional look through system in these countries, consideration needs to be given to the differential between the rates of corporate tax and income tax, to assess the extent to which this would drive the decision to opt in. Annex C2 provides a summary of the applicable rates of income tax compared to corporation tax in each of these countries. For each, while the top rate of income tax is higher than the rate of corporation tax, the difference is in no way as pronounced as in the UK.

3.24 Taking New Zealand by way of example and comparing it to the UK, in New Zealand there appears to be limited difference in the tax liability of a company making profits between £75,000 and £100,000, should it choose to be taxed on a look through basis rather than a corporation tax basis. This is compared to the UK where for profits over £75,000, the tax liability under a personal income tax system is much higher than under corporation tax. This example is predicated on the assumption that all profits of the company will be reinvested rather than extracted by way of dividends. Where profits are extracted by dividends the position becomes more marginal from April 2016 with the introduction of the dividend tax in the UK, see *Structure of company taxation* chapter.

Chart 3.B: Comparison of tax liability on an income tax basis compared to a corporation tax basis in New Zealand ("NZ") and the UK



Assumptions:

- Based on tax rates in force at April 2016
- Assumes all profits are being retained for reinvestment, therefore ignores taxation at an individual level on distribution of profits to an individual
- Ignores social security contributions

3.25 A major benefit associated with such a system not illustrated above is the ability to offset losses against an individual's other income. In the UK, this tends to be addressed by setting up as a sole trader in the early stages of a business and then incorporating once the business is profit making.

Advantages of a "look through" system of tax

- A single layer of tax for companies and their owners thereby reducing the associated administration, including the number of tax returns to be filed and tax payments to be made.

Disadvantages of a "look through" system of tax

- Where the system is opt in or by default, any significant difference in tax rates between income tax and corporation tax may influence the decision as to whether to make the election, regardless of other pros and cons.
- Is an optional system simpler or does a decision bring with it complexity?
- When there is significant differential in tax rates between the two treatments, a compulsory system with a threshold risks disparity of treatment between businesses close to the threshold.

Consolidated tax regimes

3.26 The common principle amongst consolidated tax regimes is the replacement of a number of different taxes with a single tax.

3.27 Such tax regimes seem to be particularly popular among countries in Eastern Europe, for example Hungary, where we understand increasing numbers of individuals are setting up in business in their own right.

3.28 Regimes tend to be divided between those using turnover as a starting point for tax and those using accounting net profit (or an equivalent to net profit) adjusted for certain items. For turnover-based systems, some apply the same tax to all businesses, regardless of their industry or location. This certainly feels simple, but is it fair? To address this some territories have sought to divide up businesses into categories in order to make fixed presumptions on the likely level of expenses for each category of business to conclude on an appropriate rate of tax to apply to turnover. Does this improve fairness at the expense of simplicity?

South Africa

3.29 Turnover tax was first introduced in 2009 with the objective of simplifying tax obligations for small businesses (see Annex C for the definition of qualifying businesses) whose annual turnover is no more than ZAR1million (£42,017 [2]). Turnover tax is payable at progressive rates up to 3% on turnover and replaces:

- VAT (unless a decision is made to opt back in);
- provisional tax (the system of payments on account in South Africa);
- income tax;
- capital gains tax;
- secondary tax on companies ("STC") (a tax on dividends declared by South Africa resident companies which has now been replaced by dividend tax); and
- dividend tax (tax payable by shareholders on dividends paid to them).

[2] Exchange rates obtained from https://www.gov.uk/government/publications/hmrc-exchange-rates-for-2016-monthly

3.30 The system is elective so a qualifying business can choose whether to adopt it.

Latvia

3.31 Microenterprise tax was introduced in 2010 to support those who may have lost their job start their own business. It is another example of a turnover tax, payable at a flat rate of 9% on turnover for qualifying businesses whose turnover does not exceed LVL 70,000 (£75,373) in a calendar year. Microenterprise tax replaces:

- state social contributions (for both employees and employers);
- business risk state tax; and
- corporate income tax or personal income tax, depending upon the legal form of the taxpayer.

3.32 The system has generated some concerns: that employees of microenterprises are not being provided with the minimum level of pension or unemployment benefits; and that election into the system has become tax motivated. As such, the microenterprise tax has been under review and revisions are being made to adjust the tax rate for businesses of a certain size and also to exclude businesses in certain industries.

Hungary

3.33 There are three different simplified tax regimes available.

3.34 *KATA*, the small taxpayers itemised lump sum tax, was introduced in 2013 as part of a wider program of reforms. It is targeted at very small private entrepreneurs and companies who typically don't have employees (for example hairdressers, providers of legal or accountancy services). On review of their business's tax position, most of their income was covered by costs so personal income tax liability was limited. However, they still had to prepare complicated tax returns on a monthly basis. *KATA* seeks to address this.

3.35 We understand around 400,000 private entrepreneurs and small companies have elected into paying tax under *KATA* since it was introduced.

3.36 Under *KATA*, private entrepreneurs and small companies pay a flat monthly amount to cover all of their tax obligations (including personal tax and social security contributions). However, this only provides a limited amount of social security benefits; while an individual would still receive full health coverage they only receive limited pension coverage. The threshold for the regime is set at the same level as the VAT threshold, so companies within *KATA* can also dispense with the requirement to account for VAT.

3.37 *EVA*, the simplified business tax, has been in existence for longer than *KATA* but its popularity has reduced since the introduction of *KATA*. As for *KATA* it was popular with private entrepreneurs without any employees. It is another example of turnover tax, payable at 37% in place of VAT (otherwise applicable at a rate of 27%), corporation tax and dividend tax. Historically the tax had been set at lower rates, and its increase to 37% has contributed to its drop in popularity.

3.38 One complication of the regime arose because EVA replaces VAT, requiring Hungary to pay a certain percentage of the tax take over to the EU in lieu of lost VAT revenues.

3.39 *KIVA*, the small business tax, is not as popular as *KATA* and *EVA* because it is considered too complex to apply. However, many believe the concept behind it is good. Companies that are

too large to qualify for *KATA* or *EVA* may still qualify for *KIVA,* which is available to companies with turnover of up to HUF500million (£1.14m[3]). The basis of taxation is made up of two parts:

- income provided to employees (as a replacement for social security contributions); and
- the difference in the cash of the company on the first day of the accounting period and the last day of the accounting period, adjusted for certain items.

3.40 It is the second element of the calculation that is considered complex, requiring an additional calculation and often the need of an adviser to provide assistance.

Advantages of a consolidated tax system

- Record keeping requirements should be reduced. However, for countries where there remains accounting obligations this may not make a significant difference.
- Removes uncertainty connected with which expenses can be treated as deductible for tax purposes
- Fewer filings required to be made to the tax authorities
- Generally appear easy to calculate and therefore pay tax regularly
- Potentially more predictable cash flows for businesses

Disadvantages of a consolidated tax system

- In the examples above, no account is taken of the different cost bases of different types of organisations or different industries so while a one size fits all system could be considered simple it will inevitably come with winners and losers. An optional regime may mean only those who expect to achieve a tax saving will opt in
- A turnover tax takes no account of losses generated in a particular year
- There is no incentive to improve bookkeeping, where it has been considered an issue
- It's likely to be difficult to establish an appropriate tax rate. The fact that rates, and thresholds have changed under a number of these systems supports this
- Anti-avoidance legislation may be required to prevent abuse of the rules, itself adding complexity
- There may be boundary issues, in particular for growing companies who make a transition to the 'normal' system

Cash tax

3.41 During our virtual country tour, there were few examples of a cash basis for tax accounting. However, the US does allow a cash based system of accounting for qualifying companies, those with gross receipts of no more than $5 million. An S corporation can also chose to use the cash basis instead of accruals basis regardless of size of the company or level of gross receipts, provided the company doesn't hold inventory. Private companies in the US are not required to publically disclose their financial statements, so the benefits of a cash basis for

[3] Exchange rates obtained from https://www.gov.uk/government/publications/hmrc-exchange-rates-for-2016-monthly

tax purposes is not reduced by a requirement to submit accruals based financial statements to the Registrar of Companies.

Other systems

3.42 While the Estonian system isn't unique to small companies, it is worthy of note. In Estonia there is no corporation tax; instead tax is levied at a rate of 20% on distributed profits and certain other payments made. With an ever reducing rate of corporation tax in the UK, could such a system be the answer, or does it just further increase the disparity between business owners operating as a sole trader and those operating through a company? Perhaps it depends upon the rate applied to those dividends. It would feel that it is still likely to encourage roll up of profits within the company, with a view to ultimately extracting it in a capital form. In Estonia, individuals are subject to tax at 20% on capital gains compared to dividend tax of 20% so this concern is unlikely to arise (subject to cash flow concerns).

Other taxes

VAT

3.43 During our meetings VAT has been identified as one of the taxes that can cause taxpayers problems. One way by which many countries, including the UK, achieve simplification is with the use of registration thresholds. Comparing the UK to the rest of Europe (Annex C3), we already have the highest threshold. So rather than increasing this further, could a lower threshold in fact prove more successful? This was raised periodically in meetings and we discuss it further in the *Structure of company taxation* chapter: the concern expressed was that the high threshold distorts business decisions, as evidenced by the bunching of businesses just below the registration threshold.

Administration

Australia – company incorporation

3.44 One question debated in some of our stakeholder meetings is whether incorporating a company in the UK is too easy. In response to this, we received suggestions that the process should come with guidance for those setting up in business as to their responsibilities and obligations. In one such meeting, we were directed to the Australian system which provides detailed explanation on what it means to be a company director.[4]

3.45 In particular it explains the distinction between the company and the owner, a concept that has frequently been referenced as causing confusion with business owners when first incorporating.

Australia – taxpayer relationship with the tax authorities

3.46 The Australian Tax Authority ("ATO") has been looking at its relationship with the taxpayer, following the findings of the APSC Capability Review which found that the ATO had become disconnected from sections of its stakeholders, as part of a wider reform of tax administration.

3.47 The reforms are ongoing but the overall aim is to transform the tax experience in Australia by changing the client experience, the staff experience and the culture of the ATO itself.

[4] ASIC guide for small business directors: http://www.asic.gov.au/for-business/your-business/small-business/small-business-resources/asic-guide-for-small-business-directors/

Box 3.A: In a Keynote address to the Australasian Tax Teachers' Association 27th annual conference on 20 January 2015 Second Commissioner Andrew Mills stated:

"The ATO's new mission is: 'To contribute to the economic and social wellbeing of Australians by fostering willing participation in the tax and superannuation systems.[5]"

Singapore – administering taxes

3.48 Singapore is a country that historically has tended to focus on encouraging inward investment and less focused on start-ups. While this seems to be changing, it is as a result of the introduction of lower tax rates and other incentives rather than any specific tax regime.

3.49 That said, Singapore ranks at the top of the league table in the World Bank Group's ease of doing business study, and at number 5 in terms of paying taxes. Anecdotal evidence suggests that both digital filings and the relationship with tax authority contribute to this position. The ability for companies to pick up the phone to the tax authorities and liaise with them to get timely advice on the right approach has been noted in discussions as a significant benefit.

Conclusion

3.50 The small and micro entities, while defined in different ways, appear to be an area of focus in a number of territories over recent years, with a recognition of the contribution they make to the overall economy of a country, as they increasingly represent a popular way of working for many. The aim is always to encourage and facilitate such enterprises.

3.51 It is no longer typical for people in the UK to be employees. The UK trend to work for oneself in one form or another in a flexible way seems replicated across many other countries, hence the need to assess how the tax system supports the development of these businesses.

3.52 All countries, while applying accepted approaches to simplify tax, are doing something different, suggesting there is no 'golden bullet' that will work for all countries.

3.53 The use of a "limited liability business" model, while allowing an individual setting up in business the opportunity to protect personal assets without setting up a company, will not on its own create a simplified tax system for the business. Thought needs to be given to how this new entity will be taxed.

3.54 A number of countries seem to have made successful use of other business models beyond the standard limited company or unincorporated trader. This supports the argument, developed in the *Legal issues* chapter, for a similar alternative vehicle to be introduced in the UK.

3.55 While the "look through" approach appears to have been successful and popular in the countries we've examined, those countries have a less marked difference between the income tax rate and corporation tax rate – which could be necessary to make an optional system successful. On the other hand while this disparity in rate remains, a compulsory system could be seen as unfair and met with outcry. We examine look through fully in the *Structure of company taxation* chapter.

3.56 The consolidated tax regimes appear to deliver the most simplicity to businesses. There is inevitable complexity in designing the system and drafting rules that will be successful, delivering the desired simplicity whilst ensuring the tax payable is still in line with what would otherwise arise under a standard system. This fine balance is evident by the changes that are being made

[5] https://www.ato.gov.au/Media-centre/Speeches/Other/It-s-time-for-tax-(administration)-reform/

across a number of the systems in the countries studied. However, if this can be overcome, and without the requirement for substantial amounts of anti-avoidance legislation to accompany it, such a system should deliver on an objective of simplification.

Recommendation

3.57 While we consider that a consolidated tax system could achieve a significant level of simplicity for the micro companies that are the subject of our review, the experience of other countries demonstrates that there are a lot of factors to take into account, not least whether there should be a simple, pragmatic system or one that offers a wider range of rates which may then be complex. Extensive research and assessment is required, given the risk of not achieving simplification. With the introduction of quarterly reporting under Making Tax Digital, such a system could prove popular as it would be in many ways a logical extension of the processes envisaged. However, given the pressures and amount of change with MTD, the consolidated tax idea is probably something to consider once MTD has settled down. Accordingly, **we recommend the study of a consolidated tax model as part of a longer term strategy for genuine tax simplification for micro companies (and also other micro businesses).**

3.58 **We recommend further research is undertaken to assess how such a system would be implemented in the UK.** Based on our findings, we recommend the following attributes should be considered:

- Turnover as a basis for the tax, a figure that all companies should quickly be able to assess.
- A cash basis i.e. tax is only payable on receipts so micro companies will only ever have to pay over tax once they've received the income that drives the tax liability.
- A mechanism to take account of the broad range of businesses that may opt to use such a system and their cost base. An approach using NACE codes, similar to that used in the annual investment allowance (AIA) legislation, could be considered provided it doesn't create too much complexity for diverse businesses. The chosen system would need to make it easy for a company to assess which bracket it falls in to in order to ensure simplicity of the system is maintained. This will be the aspect that will inevitably pose the greatest challenge in trying to develop such a system.
- Different tax rates or fixed deductions could be used to take account of different types of businesses.
- The consolidated tax could replace corporate tax, PAYE and NIC on salaries payable to individual business owners, where applicable, and personal income tax on distributed profits. Consideration should be given as to whether it could also cover business rates.
- A turnover threshold to assess eligibility for the system, perhaps aligned with the VAT threshold as is done in Hungary. Eligible companies could dispense with the VAT requirements should they wish at the same time as opting in to turnover tax and ensure there is only a single threshold to monitor.
- The regime could be offered to non-employing companies initially, who are likely to get the most benefit from such a system, with a view to extending.
- The system could be optional, at least to begin with, but with restriction over the ability to opt in and out.
- Whether such a system would offer genuine simplification, bearing in mind the possible need for businesses to take advice over entry to the system.

4 Structure of company taxation

4.1 This chapter introduces the different tax charges encountered by a small company and its shareholders, namely corporation tax and income tax/national insurance contributions (NIC) on profit extraction, capital gains tax, inheritance tax, VAT and business rates. The interaction and consequences on business behaviour of taxing the company in its own right on the profits derived, and on the individual shareholder on profits extracted, at the differing tax rates between labour and capital compared to those under self-employment, are reviewed here.

4.2 The chapter moves on to consider whether potential alternative taxation structures could represent a simplification for the small business, HMRC and the structure as a whole; namely:

- Look-though taxation;
- Aligning taxable profit more closely with accounting profit;
- Cash accounting;
- A combined flat-rate scheme; and
- A distributed profits tax.

Taxation of company profits; a potted history

4.3 The Finance Act 1965 replaced the previous charges on company profits to income tax and the profits tax and introduced a single tax on company profits, corporation tax (CT). However, dividend payments were charged to income tax on the shareholder under a classical system, with no credit for underlying tax, so in effect a form of double taxation applied.

4.4 In 1973, a partial imputation dividend system returned, whereby companies paid advance corporation tax (ACT) on a distribution, initially at a rate of 30%, which could be set against the mainstream CT due within certain limits, while the shareholder could set the tax credit against their income tax liability. It was only partial imputation as the rate of ACT was lower than the mainstream rate of CT. In 1993, the rate of ACT and the rate of income tax on dividends were reduced, but the tax credit continued to satisfy the shareholder's basic rate liability. In 1999 ACT was abolished, and it was no longer possible for non-taxpaying individual shareholders to reclaim the tax credit, although the basic rate liability continued to be satisfied.

4.5 On introduction in 1965, the rate of CT was set at 40%. In 1973, on the introduction of ACT satisfying basic rate income tax liability on dividends, two new CT rates were set, 52% for main companies (profits exceeding £1.5m) and 42% for smaller companies (profits below £300,000). A tapering system applied between the two, but this created a higher marginal rate within that band than the main rate itself. Subsequent Finance Acts reduced the rates of CT, down to 30% for main companies and 19% for small companies by 2001.

4.6 The Finance Act 2002 was notable for reducing the starting rate of CT on the first £10,000 profits (introduced in 2000 at 10%) to 0%. The potential for distortion in business behaviour and choice of business medium was well documented, and unsurprisingly, the level of incorporations spiked at that time, with a considerable increase in 2002/03 compared to

2001/02[1]. The distortion increased further the following year with the increase in the rate of NICs on earnings (but not dividends) of 1%.

4.7 Incorporation does provide the opportunity of converting income from labour into income from capital, where a single shareholder or a small group of shareholders control the company, by deciding in what form extraction of profits might take, e.g. as dividends or under capital gains tax on exiting the company, which do not suffer NIC. To help counter this, a non-corporate distribution rate was charged on dividends from 2004 to bring the effective rate up to 19%. From 2006 the starting rate was abolished completely.

4.8 The main rate of CT has steadily been reduced over recent years, and was aligned with small companies into a single rate of 20% from April 2015. It reduces further to 19% and then to 18% in April 2020.

4.9 A further means of extracting cash from a close company[2], by way of a loan to a participator[3] or associate[4] in the company, gives rise to a charge as if it were CT[5] at the rate of 25%, repayable when the loan is repaid. We repeatedly heard that this charge can arise due a lack of understanding by the director that the company money is quite distinct from that of the shareholder, and that drawing down in this way can result in an overdrawn director's loan account at the accounting year end. The Finance Act 2013 extended the legislation to cover loans to partnerships, LLPs and trusts involving participators in the company[6], and restricted certain repayments involving bed and breakfasting or where, at the time of repayment, arrangements had been made for further payments to replace the repayment[7]. Where the loan is on beneficial terms and the participator/associate is also an employee or director, then liability may also arise under the benefits from employment provisions[8].

Anti-avoidance

4.10 Two distinct targeted anti-avoidance provisions are relevant to the profit extraction discussions above.

4.11 In the Finance (Number 2) Act 2005, the income tax and NIC charge on chargeable benefits from employment related securities in Section 447 Income Tax Earnings and Pensions Act (ITEPA) 2003 by an associated person[9] removed the exemption where the benefit was already chargeable to tax, e.g. as dividend income, in cases involving avoidance of tax or NIC. The Paymaster-General[10] stated this measure would not affect the taxation of those small businesses that do not use contrived schemes to disguise remuneration to avoid tax and NIC[11].

4.12 The second relates to splitting shareholdings between family members, known as income splitting. Section 619 Income Tax Trading and Other Income Act (ITTOIA) 2005, the settlements legislation, can impose a charge on the settlor where they retain an interest or where income may be payable to a spouse, civil partner or a minor child (unmarried and not in a civil

[1] Department of Trade and Industry report on companies: Private company incorporations (thousands) 2001/02 224.6, 2002/03 325.2 (2003/04 388.4)
[2] Definition: Section 439 Corporation Tax Act 2010
[3] Definition: Section 454 Corporation Tax Act 2010
[4] Definition: Section 448 Corporation Tax Act 2010
[5] Section 455 Corporation Tax Act 2010
[6] Section 464A, 464B Corporation Tax Act 2010
[7] Section 464C Corporation Tax Act 2010
[8] Part 3 Chapter 7 Income Tax Earnings and Pension act 2003
[9] Section 421C Income Tax Earnings and Pension Act 2003
[10] Dawn Primarolo MP
[11] Finance Bill debate 21 June 2005

partnership). However, case law[12] has found against HMRC in a case involving splitting a shareholding between a husband and wife (or civil partners), as this particular situation falls within the exemption[13] for outright gifts between spouses or civil partners. It should be noted that income to minor children, or certain dividend waivers to spouses or civil partners would not be so exempted.

4.13 Many small companies, of course, are unaware of the detail of these provisions, and we have heard repeated calls for a simplified system at this level, which companies can opt out of. Potential alternative structures are considered further at paragraphs 4.45 onwards below.

Future of the corporation tax structure

4.14 The government have set out the intention of reducing the rate of CT further, under a UK competitiveness agenda, to 19% from 2017 and 18% from 2020. Clearly mindful of the position on tax motivated incorporations when CT rates have fallen in the past, the government have stated that structural changes may be necessary[14].

4.15 A change to be introduced from April 2016 is the new charge to income tax on dividends, subject to a nil rate on the first £5,000 dividends received. The rate of charge is set out as 7.5% at the basic rate, 32.5% at the higher rate (taxable income exceeds £42,000) and 38.1% at the additional rate (taxable income exceeds £150,000). This also represents a reversion to the classical system, with no income tax credit for the underlying CT paid by the company. A summary of the profit extraction rates, after tax, on salaries and dividends from companies, compared with self-employment taxation, are set out in Annex D.

4.16 On 9 December 2015, a consultation document was issued on company distributions[15]. The consultation period ran until 3 February 2016. It was accompanied by draft legislation to tighten the transactions in securities legislation, and introduce a targeted anti-avoidance rule to address three issues:

- 'Moneyboxing', where profits are retained in the company so they are taxed at lower capital gains rates on liquidation;
- 'Phoenixism', where the shareholders enter into a members voluntary liquidation, and then continue business via a new company, having accessed favourable CGT rates; and
- Special purpose vehicles, where the business is capable of being divided between different companies, each running particular projects and which are liquidated once the projects are concluded, again accessing reduced CGT rates.

4.17 The consultation document moves on to consider whether a return to close company apportionment may be a solution to the issues above. Close company apportionment applied until 1989[16]. Broadly, the legislation provided that if a close company did not distribute a reasonable amount of its total income in such a way that the distributions formed part of the total income of the shareholders for tax purposes, then the company's income was, subject to

[12] Jones v Garnett [2007] UKHL 35.
[13] Section 626 Income Tax Trading and Other Income Act 2005
[14] David Gauke MP, Financial Secretary to the TReasury: Britain, Europe and Tax Competition conference 1 June 2015
[15] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/483547/Company_distributions_-_consultation_document__7029_.pdf
[16] Sections 423-430 Income and Corporation Taxes act 1988

complex rules, treated as income of the members. Effectively, the undistributed income was apportioned, or notionally distributed, amongst the members.

4.18 These proposals are attempting to address the distortions in the current tax structure for small businesses. This problem was already set out in the Mirrlees review[17], which concluded 'the UK experience lends strong support to the argument that the tax system should not set to favour one legal form over another.'

4.19 The OTS has therefore considered below whether alternative taxation of profit structures could represent simplification.

Capital gains tax (CGT) for companies and shareholders

4.20 Companies do not pay CGT, apart from disposals of high value residential property where the annual tax on enveloped dwellings (ATED) is payable. Instead, they are charged to CT on their chargeable gains (after indexation allowance, which was abolished for individuals and trustees from 1998).

4.21 However, as noted in the Company Distributions consultation document above, CGT is chargeable on the shareholder, on disposal of all/part of their shareholding, or on liquidation of the company, or on informal striking off where total distributions do not exceed £25,000.

4.22 CGT (after the annual exemption) is charged at 18% for basic rate payers, and 28% for higher rate taxpayers. However, where the conditions are satisfied, entrepreneurs' relief (ER) will charge lifetime gains up to £10m at 10%. The conditions are that for the 12 months before the date of disposal (or the date of cessation of trade by the company, where the disposal is made within 3 years of that date) the:

- Individual owns 5% of ordinary share capital and votes;
- Individual is an employee or officer; and
- Company is a trading company, or the holding company of a trading group.

4.23 A number of restrictions to ER were introduced in Finance Act 2015[18]. There is a measure of double taxation when the company disposes of a chargeable asset, such as land or goodwill (CT on the chargeable gain on the company and income tax or CGT on the distribution of the proceeds to the shareholder). This is particularly relevant on closing the company, and is discussed further under disincorporation relief in the *Company lifecycle* chapter.

4.24 We were told of confusion between the entrepreneurial reliefs of ER, enterprise investment schemes (EIS) and research & development by small businesses. We heard that the title 'entrepreneurs' relief' is not considered to be about entrepreneurship at all, coming at a time when the individual is exiting the company. Our sense is that there is merit in a proper study of the effectiveness of entrepreneurs' relief. (The OTS has previously made recommendations for some improvements to the working of the relief.) The structure of CGT and business asset reliefs has been noted as a potential future review for the OTS and we make no further comment on these aspects in this report.

[17] Mirrlees Dimensions of tax by design: Chapter 11 Small business taxation

[18] Of particular relevance to small companies is the restriction that ER is not available on the transfer of goodwill on an incorporation, where the individual is a related party to the close company, essentially a participator (or associate) in the company. The restriction does not apply to a retiring partner, unless they are related to such a participator. This provision applies to transfers on or after 3 December 2014, and along with section 26 which restricts the write-off of goodwill against profits, are ostensibly to remove these tax incentives to incorporate, where the trade remains in the same economic ownership.

Inheritance tax (IHT)

4.25 There are three main provisions where IHT needs to be considered by the small company.

(1) Where a close company makes a transfer of value, the value is apportioned among the participators according to their respective rights and interests in the company immediately before the transfer.

(2) Unquoted shares in the company are relevant business property, and subject to satisfying the conditions[19] for business property relief purposes (BPR), qualify for 100% relief. Land and machinery, owned by a controlling shareholder, and used wholly or mainly for the purposes of the business carried on by the company, subject to the conditions for BPR purposes, qualify for 50% relief.

(3) Occupation of agricultural property by a company which is controlled by the transferor, subject to satisfying the conditions[20], qualifies for agricultural property relief (APR).

4.26 The IHT reliefs were mentioned in various meetings but no particular problems were cited. Awareness seems high, but they have been noted as a potential future review area for the OTS, and no further comment is made in this report.

Value added tax (VAT)

4.27 As a legal person, the limited company becomes a taxable person if it is voluntarily registered for VAT (having taxable supplies), or is required to register for VAT as the total value of taxable supplies exceeds the threshold, currently £82,000, in a 12 month period (including reverse charge procedures on goods from the EU) or expected to exceed the threshold in a 30 day period.

4.28 We heard on a number of occasions there is a logic in significantly reducing this threshold:

- To improve fairness in the system (as businesses are more likely to be trading on the same basis rather than some receiving a perceived advantage by not having to charge VAT);
- To reduce the incentive to keep businesses below the threshold[21]: statistics show considerable 'bunching' of businesses just below the registration limit (and so by corollary encouraging growth);
- It may contribute to closing the VAT gap by removing the incentive to suppress sales.

4.29 At the same time, by bringing a lot more businesses into the VAT system it would create considerable additional administrative and compliance burdens. We make no formal recommendation about the VAT registration threshold as it is a policy matter but suggest that the issues raised in our evidence gathering need to be considered by policymakers.

4.30 But the main concern we heard about was the effect of the cliff edge, wherever it occurs, particularly in the case of those businesses unable to pass the charge onto the customer. We

[19] Part V, chapter I Inheritance Tax Act 1984
[20] Part V, chapter II Inheritance Tax Act 1984
[21] A particular example was given to us in relation to businesses in holiday areas where many take stock at the end of the peak season to decide how much longer to stay open – the point being they want to stay under the VAT threshold

were also told of a number of administrative points on VAT, which are looked at further in the *Administrative aspects* chapter.

4.31 From 1 January 2015, for EU cross border supplies of digital services, there is no registration threshold and VAT is charged at the rate due in the consumer's country. That means the company must either register in each EU country where they make digital supplies, or register under the Mini One Stop Shop scheme (MOSS). We heard this is overly complex, and note the issue of further evidential simplification and guidance for small businesses[22]. We discuss this further in the *Administrative aspects* chapter.

4.32 A number of alternative VAT accounting schemes are referred to below.

VAT flat-rate scheme

4.33 A VAT registered company can join the flat-rate scheme (FRS) where it expects the value of its taxable supplies (excluding VAT) will not exceed £150,000 in the coming 12 months. The company must exit if on an anniversary of joining, taxable supplies including VAT exceeded £230,000 in the previous 12 months, or is expected to do so in any coming period of 30 days alone.

4.34 In summary, instead of paying HMRC the difference between output tax charged and input tax suffered, the company charges VAT in the normal way but simply applies a flat-rate to taxable turnover and pays that over to HMRC. This means that input tax suffered cannot be reclaimed, except capital expenditure goods, bought as one purchase, costing £2,000 or more including VAT, or VAT paid on goods and services before registration subject to conditions. The amount of the flat-rate percentage depends on the business type, and a 1% reduction to the rate applies in the first 12 months of VAT registration (not necessarily the first 12 months in the scheme). The turnover can be measured on the basic invoice tax point basis, or on a cash basis.

4.35 From our discussions with advisers there appeared to be a lack of awareness of the scheme among businesses[23]. This point is taken up in the *Administrative aspects* chapter. One request was made for joint registration of VAT and the scheme. We heard that the inability to reclaim on purchases (other than above) could cause cash flow issues, but these tended to be outweighed by the simplification benefits. However, we also heard a number of times that the scheme was more complicated than it first appears.

4.36 We also heard understandable requests for the threshold to be increased. Overall, we think there is a need to increase awareness of this and other VAT simplifying schemes.

VAT cash-accounting scheme

4.37 Normally, VAT is payable by reference to the VAT on taxable sales invoices in the quarter less VAT on non-exempt purchase invoices in the quarter. Under the cash accounting scheme, VAT is payable on receipts from the customer, less VAT on purchases when paid.

4.38 A VAT registered company can join the scheme where it expects the value of its taxable supplies will not exceed £1.35m in the coming 12 months. The company must exit if annual taxable supplies exceeds £1.6m.

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[22] Revenue & Customs Brief 4 (2016) published 8 January 2016.

[23] One business commented to us that they were not aware of the system until after a few years they went to an adviser. They were now using it and it was beneficial; their question was in terms of why had they received no prompts about the existence of the scheme from HMRC?

4.39 The scheme offers automatic bad-debt relief, and with those users of the scheme we heard no particular issues with its operation.

VAT annual accounting scheme

4.40 VAT is normally reported and paid at quarterly intervals. The annual accounting scheme allows monthly or quarterly instalments to be paid based on the previous year's return, with balance due within two months after the end of the accounting year.

4.41 Eligibility is as for the cash accounting scheme above. Its benefit is to even out the payments for companies with fluctuating profits. We heard no comments from companies regarding this scheme.

Business rates

4.42 Although non-domestic rates (NDR or business rates) are not under the remit of HMRC, we have considered all taxes and duties that impact on small businesses as stated in the terms of reference for this review, following issues raised in previous OTS projects[24]. NDR was a subject raised regularly by businesses in our discussions, often in the context of the tax that caused them most difficulties.

4.43 A number of calls were made for more frequent valuations, which would bring the system closer to pertaining economic conditions, and address many of the business rating issues. We heard various calls for exemptions, modifications and reliefs, often with reference to the changing nature of retailing in the face of the digital economy. Some suggested that the NDR system placed a disproportionate administrative burden on the smallest companies.

4.44 The government is currently undertaking a review of business rates, which will report at Budget 2016. We make no recommendations in this report as there is no sense in our trying to anticipate the results of the work; we have fed into the review team what we have heard in our discussions.

Alternative taxation of profit structures

4.45 The OTS have reviewed a number of alternative structures, to determine whether such a system could represent a simplification for small companies.

Look-through taxation

Background

4.46 As discussed in the *International* chapter, a number of countries operate a 'transparent' taxation of small company profits. We have considered a version of a transparent tax which we

[24] In England and Wales, business rates are calculated using the rateable value at 1 April 2008 and applying a 'multiplier' set by central government for the year, dependant on whether the property is located in Greater London, rest of England or Wales, with a lower rate applying for small businesses, i.e. rateable value below £18,000 (£25,500 in Greater London).
In England, small business rate relief may be claimed at 100% (double the normal rate until April 2017) where the rateable value is £6,000 or lower, with a tapered system applying 100% to 0% for rateable values above £6,000 up to £12,000. Different rules apply where more than one property is held. Other reliefs, rural relief, charitable relief, enterprise zone relief, exempted buildings and retail relief may be claimed. Small business relief also applies at the same rates in Wales.
In Scotland, a 'poundage' rate is applied to the rateable value. The small business bonus scheme exempts rateable values up to £10,000, with 50% relief between £10,001 and £12,000 and 25% relief from £12,001 to £18,000.
In Northern Ireland, small business rate relief applies at 50% to properties with net annual value up to £2,000, 25% from £2,001 to £5,000 and 20% from £5,001 to £15,000.

refer to in this report as 'look-through' taxation. Further details of these countries' tax systems are set out in the International chapter.

4.47 The principle of a transparent tax would be to look through the company structure, and assess the profits of the company directly on the members of the company. With look-through the shareholders, or the directors, depending on the design of the system, would be assessed to income tax and national insurance contributions (NICs) on their share of the profits.

4.48 The simplest design would mean looking at the respective ownership of the company, and apportion the profits accordingly, in a similar fashion to the taxation of a partnership. One immediate issue would be whether salaries paid would be disregarded and so 'full' profits are apportioned; or whether apportioned profits are measured after remuneration, which would be subject to PAYE in the normal way. Either route would mean dividend distributions would not be subject to tax as the profit share has already been charged[25].

4.49 Deduction of salary would use the profit chargeable to CT as the amount to be apportioned. However, this would leave PAYE and NIC compliance obligations in place. Apportioning between shareholders before deduction of their salary and benefits could potentially remove PAYE and P11D obligations, although a partnership style allocation of profits would then be necessary. The two methods produce different taxation results – see box 4.A.

4.50 **The OTS concludes that apportionment before salary has the greater potential for simplification, although comes at a tax/NIC cost. It would also be consistent with the tax paid by the self-employed[26].**

4.51 A comparison of the marginal extraction rates after tax between self-employment, and incorporated extraction, are set out in Annex D1. It is worth emphasising that for companies with profits (on the before salary basis) exceeding £13,000, a look-through basis will cost more in tax and NIC (the profit cross over point on the 'after salary' basis rises to £26,000 where profits are fully extracted). The position is then reversed when profits exceed £175,000. These figures are based on a single shareholder company, where profits are fully distributed.

4.52 Table 4.A sets out the profit extraction under the above three routes, assuming single shareholder company, salary paid equal to the primary earnings threshold, and profits fully distributed (workings set out in Annex D2):

Table 4.A: Profit extraction under look-through and existing corporation tax regimes

Profit (before salary £8,060)	Limited company – current system – profits extracted after tax	Look-through before salary – profits extracted after tax	Look-through after salary – profits extracted after tax
£10,000	£9,612	£9,679	£9,854
£25,000	£21,191	£20,529	£21,255
£50,000	£39,691	£37,369	£37,605
£100,000	£67,038	£66,369	£66,531

Source: Computations based on Finance Bill 2016 tax rates and allowances

4.53 See box 4.B below for an example where profits are not fully extracted.

[25] The legal requirements of paying a dividend would still apply.
[26] Though of course not the same as an employed person where employers' NICs would still be relevant as well.

Box 4.A: Tax paid under look-through and corporation tax

For example, a company with two equal shareholders, pays a salary equivalent to the primary earnings threshold of £8,060 to each of them, profits for CT purposes are then £40,000 which, say, are fully distributed as dividends.

Under the current system, the following tax is due:

Corporation tax £40,000 @ 20% = £8,000

Income tax on dividends on each shareholder (£16,000 – personal allowance after salary £2,940 – dividend allowance £5,000) @ 7.5% = £604.50

Total tax due £9,209

Under a look-through system with apportionment after salary, the following would be due on each shareholder:

Income tax (£20,000 – personal allowance after salary £2,940) @ 20% = £3,412

Class 4 NIC (£20,000 - £8060) @ 9% = £1,074.60

Total tax £8,973.20

Under a look-through system with apportionment before salary, the profits of £56,120 are divided between the two and include the salary drawn, so the following tax is due on each shareholder:

Income tax £28,060 – personal allowance £11,000 @ 20% = £3,412

Class 4 NIC (£28,060 - £8,060) @ 9% = £1,800

Total tax £10,424

4.54 The areas we have explored at our various meetings with advisers, businesses and representative bodies have been:

- Whether such a system should be operated as compulsory, or optional, or by default with an opt out;
- Which companies would be included; and
- Whether such an approach represented simplification.

4.55 We are aware that a look-through basis is seen by some as a way of dealing with the issue of IR35 (as it could become redundant to a degree, though on the design suggested above it would not involve employers' NICs and so would not replicate employment). The reduction in corporate tax rates are seen as having the potential to create more incentives to incorporate (though the new system of dividend taxation seeks to manage this), and look-through could also address this. These are in many ways policy matters rather than simplification issues, but we have naturally discussed them in meetings and have considered them in our evaluation of look-through.

Box 4.B: Look-through examples comparing profit retention

The following two examples assume look-through applies to profits after deduction of salary, and to make a meaningful comparison, that an equivalent salary is drawn under the look-through calculation.

John has high growth plans for his newly formed company. He owns 100% of the share capital. In the first year to 31 March 2017, profits (after salary equal to the NIC primary earnings threshold (£8,060), but before capital allowances) are £60,000, of which £30,000 are reinvested in office equipment qualifying for capital allowances, with £20,000 withdrawn as dividends.

Under the current tax system, the following tax is due:

Corporation tax (£60,000-capital allowances £30,000) @ 20% = £6,000

Income tax on dividends (£20,000 – personal allowance after salary £2,940 – dividend allowance £5,000) @ 7.5% = £904.50

Total tax due £6,904.50

Under look-through taxation, the following tax would be due:

Income tax (£60,000-capital allowances £30,000 – personal allowance after salary £2,940) @ 20% = £5,412

Class 4 NIC (£60,000-capital allowances £30,000 - £8,060) @ 9% = £1,975

Total tax due £7,387

Terry has started to trade from a company, and wishes to work enough hours to make ends meet, with no plans to grow the company. Profits are £20,000 (after salary equal to the NIC primary earnings threshold (£8,060)), and after CT are fully withdrawn from the company as dividends.

Under the current system, the following tax is due:

Corporation tax £20,000 @ 20% = £4,000

Income tax on dividends (£16,000 – personal allowance after salary £2,940 – dividend allowance £5,000) @ 7.5% = £604.50

Total tax due £4,604.50

Under the look-through system, the following would be due:

Income tax £20,000 – personal allowance after salary £2,940 @ 20% = £3,412

Class 4 NIC (£20,000 - £8060) @ 9% = £1,074.60

Total tax £4,486.60

John is withdrawing only one-third of profits, reinvesting for future growth, and he would pay an additional £482.50 under a look-through system.

However, Terry is withdrawing all profits, having no plans to grow the company, and would actually pay £117.90 less under an after salary look-through system.

Findings

4.56 Many of the views we heard on this subject were diametrically opposed, and always led to lively debate. To give a flavour:

- A professional body was strongly in favour of the introduction of a look-through system. Their rationale being that the current tax structure was distorted between self-employment and incorporated businesses. This inevitably resulted in taxation being a factor that needed consideration by the business and their adviser when deciding which business medium to use. Look-through would remove this issue, and incorporation would become a wholly commercial decision.
- In the opposite corner, many advisers we spoke to were against introducing a look-through system. They said that the proposal would mean the introduction of an immediate tax on profits that were not being withdrawn, and which were being reinvested in the business.[27] They considered that such a move, if compulsory, would restrict growth, harm investment and affect entrepreneurship in particular.
- We received a number of submissions calling for all self-employed, including the 'incorporated self-employed' (i.e. those working through a limited company) to be taxed in the same way and at the same rate, even where this was likely to cost the respondent more in tax.
- There was also support, if the design of the look-through system allowed, for removal of form P11D where there were no employees, and also allow access to the self-employed fixed rate expenses.
- Many respondents felt the different business forms should pay equivalent amounts of tax.
- We have evidence from the online survey and from meetings that the current system creates issues for businesses, with statements such as "Corporation tax and dividends versus director loans, it's all very confusing". Representative groups have told us these issues are too complex for businesses to fully understand, and this is likely to be exacerbated by the introduction of the new dividend taxation from April 2016.
- We heard that, in particular, those previously self-employed may struggle with the additional tax and administration burdens of running the company.
- The OTS online survey showed 31% agreed or strongly agreed that a different tax structure such as look-through would be helpful, even if this resulted in losing some tax advantages.

4.57 If the look-through system were to be optional, many advisers considered it unlikely that any business would choose such a system. Unlike in the US or New Zealand for example, who operate a successful look-through model, the tax differential in the UK was in favour of the

[27] This is an echo of views expressed to us during our partnerships project. Many said that a key problem with the partnership form of business was the inability to retain profits for investment without them being subject to full income tax and NICs. That led us to suggest that reforming partnership tax so that profits were taxed at 20% (i.e. income tax basic rate) until they were handed out to partners (when higher income tax rates would apply) might be worth considering properly. We readily acknowledged that such a system would arouse concerns about avoidance and that if partnerships wanted to have the possibility of retaining profits they could operate through a limited company structure, assuming that was possible in their area of business.

current system, i.e. tax savings resulted from operating through a company rather than being taxed fully to income tax.

4.58 However, we were also told that tax was not the primary reason for incorporation (see *Executive review* and the *Legal issues* chapter).

4.59 The OTS Small Business Review[28] found that a significant number of small businesses had no plans to grow[29]. More recently, an HMRC Research Report[30] found 62% of non-employee companies surveyed did not expect to grow, and this report is considered below. Such businesses may find themselves in a limited company for reasons other than taxation. The evidence we have heard in this project is that this conclusion remains valid. Accordingly, we can see that there are many companies that are never going to be other than small, proprietor owned and staffed, with few assets and which could be considered separately from 'growth' companies in this debate.

Universal Credit

4.60 We met with the Department for Work and Pensions (DWP) to discuss the project and in particular the link to Universal Credit (UC). For UC reporting purposes, where a person stands in a position analogous to that of a sole owner or partner in relation to a company, that person will be required to report (monthly) on a look-through basis, as if the profits (or profit share) were their own self-employed earnings[31].

4.61 Claimants of UC would be likely to welcome look-through taxation, as this basis would be a consistent with their reporting obligations when making their claim.

Evaluation of look-through and conclusions

4.62 It is necessary to consider whether a look-through system would represent simplification. It would mean:

- Introduction of further legislation;
- If look-through is not to be made compulsory, then eligible companies would need to choose between the current system and a new look-through system. Choice represents complexity, and the benefits would need to outweigh this;
- Decision on whether salary payments made would stand or would be 'written back';
- Defining eligible companies or those that have to apply the system;
- Setting up return procedures to cater for those companies and shareholders affected;
- Whether the system would be optional, default with opt-out or compulsory, the risk being that an optional system may simply generate complexity and extra advisory work with decisions based solely on which route brings the lower tax bill;
- Developing rules that would cater for changes in shareholdings;
- Policing the new system; and

[28] https://www.gov.uk/government/publications/small-business-tax-review
[29] The Futures Company research January 2012 – 39% small businesses not planning to grow.
[30] Ipsos MORI HMRC Research Report No 390 (September 2015): Profit Distribution and Investment Patterns of Unlisted Companies
[31] Reg 77 Universal Credit Regulations 2013

- Companies would presumably still have to do normal Companies House reporting but it may be possible to streamline some aspects and generally look for combined HMRC and Companies House reporting/filing.

4.63 The OTS believes that a compulsory look-through system across all companies would impact on the level of corporate investment, which would be counter to the rationale behind reduction of corporation tax rates, and the government's UK competitiveness agenda.

4.64 It would also add to complexity for many businesses seeking investment in order to grow, as investor shareholders would face increased compliance reporting their share of profits. Additionally, high-growth businesses would quickly move from one taxation system to another when no longer eligible under whatever size definition is put in place.

4.65 The OTS considers there is a possible target range of lifestyle type companies, which:

- Do not intend to increase in size;
- Are effectively one-person businesses;
- Distribute all their profits; and
- Have few assets or need for investment funds.

4.66 The HMRC research report into Profit Distribution and Investment Patterns of Unlisted Companies[32] found that 62% of non-director employee companies did not expect to grow. 14% of companies with no staff did not retain profits, and these companies were less likely to hold net assets.

4.67 The research report sets out the median turnover for companies without retained earnings as £75,000, and the OTS consider this turnover limit could apply to limit the sub-set of non-employing companies as those eligible for a look-through system.

4.68 For these, the introduction of look-through taxation system could indeed represent a simplification

4.69 The following advantages may apply:

- It would avoid problems with drawings and loan accounts.
- Simpler to comply and greater certainty on tax payments – one income tax return compared to an income tax and a corporation tax return, a system that those previously self-employed would be used to
- Dividend taxation no longer applies compared to reporting both profits and dividends
- For those claiming Universal Credit, the look-through system could be consistent with the claim they would need to make.
- Choice of business medium becomes a wholly commercial one for those businesses opting in

4.70 It may also prove useful for those businesses that would dis-incorporate (see *Company lifecycle* chapter) but for the loss of limited liability.

4.71 On design of the system, one representative body suggested to us that a turnover limit be applied for eligibility, and that once in there should be a requirement to remain within the

[32] Ipsos Mori HMRC Research Report No 390 September 2015

system for five years, or until the company turnover reached a certain higher point. However, we have not yet been able to fully consider eligibility conditions, or the transitional provisions of entry/exit to the regime, the treatment of losses and other design arrangements.

4.72 In principle, the OTS can see that a look-through system of entry for eligible companies offers scope for simplification. The high growth companies, who would not be interested, would be more likely to seek advice on considering their options and taking a conscious decision to opt out, if allowed. However, we do not underestimate the difficulties in defining the system and are concerned that the result could be to push small companies into needing to take further professional advice on how to proceed. In particular this could be an assessment solely based on which route brings the lower tax bill.

4.73 **Aside from the tension between the potential simplification benefits versus the complexity in adding a choice of system, as noted at the start of this section, there are wider considerations around IR35 and falling corporation tax rates. We therefore recommend a full consideration into the design of a look-through system for this target range of companies. We recommend that the OTS develops an outline of such a system for fuller debate. This needs to include whether the system would be compulsory, default with opt-out or optional.**

Alternative methods

4.74 We now consider four alternative methods:

1. Alignment of taxable and accounting profits
2. Cash accounting
3. Distributions tax
4. Alternative tax calculations such as a turnover tax

1. Align taxable profit more closely with accounting profit

4.75 In October 2014, the OTS published the UK Competitiveness Final Report[33], which set out the typical response to our question on what an ideal CT regime would look like:

Box 4.C: An ideal corporation tax regime as expressed by respondents in the UK Competitiveness Final Report

CT should be a tax on business profits arrived at after deducting all legitimate business expenses, the profits being those disclosed by the business accounts. There should be a minimum number of adjustments and these should be in accordance with a clear and well understood policy.

4.76 Our report also noted a feature of the CT computation of many companies was the adjustment to the accounts profit to replace the charge for depreciation[34] with capital allowances. Whilst in the past the writing down allowance may have been higher than the typical depreciation charge, the reductions in the rate from 25% to 18%, or 8% in the case of integral features and long life assets[35], mean this may no longer be the case.

[33] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/362302/competitiveness_review_final_report.pdf

[34] Application of proper accounting standards will write off the capital expenditure over the useful life of the asset

[35] Life greater than 25 years

4.77 But capital allowances also add complexity. The system allows relief on certain assets only, with case law providing the boundaries where it was unclear whether expenditure qualified for the allowance, and new issues continue to emerge. Whilst the actual calculation is straightforward, normally relying on appropriate software, the need to identify capital expenditure by the business's adviser can be time consuming.

4.78 Our recommendations for simplifying the corporation tax computation were generally accepted, though we are not aware of any formal work on the proposals.

4.79 A further recommendation in the above report, independent of wider decisions on capital allowances, was for consistency in the level of the 100% annual investment allowance (AIA), following the confusion reported by companies on the frequent changes to the limit over recent years. The OTS were pleased to see the AIA being made permanent, at a level of £200,000[36].

4.80 Stakeholders informed us that the vast majority of micro companies would be unlikely to exceed this level of AIA. Therefore it is likely to enable most small companies to effectively be on a cash basis for expenditure qualifying as plant for capital allowances. It follows that a move to tax deductible depreciation, which under proper accounting standards would mean writing off over the useful life of the asset, is unlikely to be as beneficial for those assets qualifying for AIA.

4.81 The move to more frequent reporting under Making Tax Digital (MTD), and the need to make this obligation as light touch as possible, brings these recommendations into sharper focus as without such a change, the digital agenda will be more complex. We also repeatedly heard that accounts filing was found to be easier than tax filing, with more coverage in the *Administrative aspects* chapter. We therefore repeat our recommendation that work needs to be undertaken on whether many of the 'sundry tax adjustments' could be eliminated. In recommending this, we are aware that smaller companies will naturally have fewer such adjustments to make, but the range of adjustments is still extensive and needs to be considered.

4.82 The fixing of the AIA at a high level means that almost all micro businesses, and most small businesses, will effectively be on a cash basis for capital investment (as few will invest in buildings). Moving to tax deductible depreciation as a replacement for capital allowances is unlikely to be attractive, and the AIA therefore needs to be retained for these businesses.

2. Cash accounting

4.83 In the OTS Small Business Tax Final Report on Simpler Income Tax for Small Business[37], a recommendation was made for the introduction of a receipts and payments accounting system for income tax purposes by unincorporated businesses, which became known as the cash basis.

4.84 The Finance Act 2013 adopted this measure, albeit using a higher turnover threshold and further legislation measures than those proposed by the OTS. That said, take up of the scheme by unincorporated businesses has proved very successful, with 1.11 million sole traders and 39,000 partners[38] opting into the scheme (the OTS had proposed a default system, but a tick on the self-assessment return is necessary to join).

4.85 The OTS report set out that once the simplified scheme was established for unincorporated business, work should be carried out to see how the advantages could be made available for the corporate sector.

[36] Section 8 Finance (Number 2) Act 2015, although the legislation does not prevent future change or repeal

[37] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/199180/02_ots_small_business_tax_review_simpler_income_tax_280212.pdf

[38] KAI figures

4.86 At the vast majority of meetings we have held under the current review, advisers and small companies have been in favour of a receipts and payments accounting approach to taxation for small companies.

4.87 However, limited companies are subject to formal financial reporting requirements, which are bound by EU directives, and these are set out in more detail in the *Legal issues* chapter. Even the basic micro entity accounts are required to be completed on an accruals basis, albeit along the lines of receipts, payments and debtors for the most straightforward businesses (informally known as cash accounting plus). We spoke to the Department for Business, Innovation & Skills (BIS), and were told there was no discretion to allow cash accounting under the EU directives, which were in place to protect shareholders and creditors under limited liability.

4.88 On explaining that accruals accounting is required for Companies House submission, we found the appetite for cash accounting purely for tax purposes to be considerably diminished. The aim as far as we and our stakeholders are concerned would be to have one form of report required which would satisfy both Companies House and HMRC requirements: that would be a clear simplification.

4.89 The MTD agenda of quarterly updates and payments has sharpened the focus of this concept and the OTS are aware of a train of thought that making interim payments under a 'GAAP lite' (or preferably cash basis) arrangement may be a simplification despite the need for full GAAP compliant accounts for Companies House. As the publication of the MTD road map was made towards the conclusion of our evidence gathering period for this report, we have not had the opportunity to fully test that theory.

4.90 The OTS would like to recommend the introduction of cash accounting for tax purposes, but concede this only represents real simplification if additionally applying to financial accounting, which is not possible under the current EU directives (see the *Legal issues* chapter for more information).

4.91 What this emphasises is that with the high AIA, many small companies are effectively on a cash basis for tax, except for sundry adjustments. Eliminating most of those (so that any expenditure for the business is tax deductible) will mean that corporation tax is effectively on a cash basis. The ideal simplification is clearly that accounts and tax are in step though it seems at the moment this will not be possible as accounts will have to be on a GAAP/accruals basis. If that is not possible, the target must be to get the tax computation to be as far as possible on a cash basis, something that will therefore flow easily from the most basic records and will then work for MTD. The accounts would then be a post-year end adjustment, in effect.

3. Distributed profits tax

4.92 We have also considered the concept of replacing corporation tax with a distributed profits tax. This tax would be set at a higher rate than CT, but would only apply when a dividend distribution was made.

4.93 Whilst such a scheme would appear cheaper and simpler to apply, it is acknowledged there would need to be certain minimum dividend distribution levels and/or maximum cash held within the company, to address avoidance concerns. This would introduce considerable complexity and would not appear to meet simplification criteria.

4. Simplified flat rate scheme

4.94 In the interim Small Business report issued March 2011, the OTS floated the concept of a flat rate scheme, which applied in certain other countries in the form of a 'consolidated tax' scheme (see the *International* chapter for a full discussion). However, cash accounting was the

preferred option for development, and this was introduced for unincorporated businesses in the Finance Act 2013.

4.95 Such a consolidated scheme builds on the VAT flat-rate (FRS) scheme, whereby the business is categorised, with all businesses in that category assumed to have similar costs as a proportion of turnover. Under the FRS scheme, HMRC already provide such a percentage to arrive at profit after VATable expenses, and all that is now required is for HMRC to provide a percentage additionally to estimate the non-VATable expenses.

4.96 The Federation of Small Business (FSB) have suggested a scheme for discussion that could be extended to include an alternative to business rates[39], and a simplified quarterly payment of employers NIC, based on the amount of employee NIC x employer NIC rate/employee NIC rate. We have taken these routes, including the one put by the FSB, into consideration in our various meetings held with stakeholder groups.

4.97 At a number of meetings, we have heard that the different return and payment dates for various taxes cause confusion for small businesses. The consolidated scheme has the advantage of paying VAT and CT at the same time, taking three figures from accounting records, namely turnover, employment costs and interest paid.

4.98 This would appear to provide greater certainty of tax liability, and be simpler for businesses to follow the MTD planned changes on reporting and payment. Entry requirements would need to be reviewed in terms of turnover or other threshold, and an agreed minimum period arrived once in the arrangement.

4.99 We have also been told that whilst the VAT flat rate scheme works well for those businesses opting in, it should be remembered that VAT is a tax on transactions, whilst CT is a charge on company profits; at one meeting it was felt that profitability of businesses varied hugely, even within given categories, so that an incorrect percentage being applied to turnover could have dire financial consequences. Others had concerns on cliff-edges at the margins.

4.100 We also heard at a meeting that the proposals on MTD and the concerns of businesses of increased compliance may be partly addressed by the use of a simplified system in making interim payments, but only where a final return and payment sweep up (or "day of reckoning") remained in place. However, the MTD road map was published towards the end of our evidence gathering period, and we therefore have not been able to fully test this suggestion.

4.101 A simplified system for calculating and paying different taxes at once has a real attraction, particularly in the climate of MTD. However, the OTS is mindful of the concerns in the paragraphs above, and considers further research and consultation would be necessary before recommending such arrangements. Further comment on this is included in the *International* chapter recommendations.

Conclusion on the four methods

4.102 In an ideal world, we would see the extension of cash accounting to small companies as a real simplification, but accept this will need changes to the financial reporting regulations.

4.103 Looking at the above four alternative forms of taxing the company, aligning taxable profits with accounting profits becomes our preferred round. However, with the high and long-term AIA, such a route is unlikely to be popular for small companies.

[39] A study commissioned by FSB "Proposals for reform of the non-domestic rating system" conducted by the Centre for Economics and Business Research, found business rates could be replaced by a 1% charge on turnover.

4.104 This brings us back to a cash basis, and if accounts cannot be prepared on a cash basis, the push must be to simplify the tax calculation to as near a cash basis as possible. That means eliminating the sundry tax adjustments as far as possible so that cash figures can flow into Making Tax Digital requirements. Given the MTD agenda, we feel this proposal should be given immediate priority.

4.105 The OTS do not consider a change to a tax on distributed profits would represent simplification, and whilst a flat-rate scheme would be possible in the longer term, other proposals above offer more certain resulting benefits. In the *International* chapter we have recommended a long-term study of a consolidated system.

5 Administrative aspects

Overview

5.1 The overwhelming message arising out of engagement with owner-managers, interest groups, agents and representative bodies was that as small companies they wanted to be compliant, which was why for the most part they engage agents (91% of all the smallest companies have agents[1]). Understanding the statutory account compliance requirements was the biggest issue that that they face:

> **Box 5.A: Small business adviser**
>
> "It's the accounting standards, the tax side is fairly simple."

5.2 It was clear from our engagement process that for most small business advisers, taxation, especially corporation tax (CT), was merely seen as a bi-product of the year-end accounts production process. Despite feeling detached from the taxation of their companies a number of key themes in respect of areas requiring simplification arose out of the OTS's stakeholder engagement. For example, a requirement for common filing and payment dates in respect of statutory accounts, corporation tax returns and the associated payment of tax (5.27 below) and a cross government department registration for new companies (5.28 below).

5.3 While not an issue of taxation, concern was raised by stakeholders in respect of the relative ease of forming a company. Some of those consulted were concerned that fundamental mistakes made on formation subsequently prove costly to put right, for example allotting themselves large amounts of shares because it seemed a good idea at the time (see the *Lifecycle* chapter).

5.4 Others were concerned over the potential scope for criminals to exploit the ease of incorporation in the UK. The absence of advance clearances across the various heads of duty was a common concern.

5.5 While the OTS is charged with reviewing existing legislation and current administrative practice for areas of potential simplification, the recent HMRC launch of Making Tax Digital (MTD), with its proposal to mandate the use of accounting software and quarterly reporting is of such fundamental significance that it simply could not be ignored. As a consequence a significant portion of this chapter is dedicated to the early emerging thoughts garnered from the OTS's engagement with interested parties.

The administrative burden over the last 20 years

5.6 Owners said that they have experienced a sustained and prolonged increase in their administrative burden on all fronts over the last 20 years. The following were cited as examples of increased administration:

- payroll reporting under real time information (RTI);
- employment law;

[1] Ipsos Mori Social Research Institute report "Understanding tax administration for businesses" HMRC Revenue and Customs Research Report 375

- national minimum wage;
- health and safety;
- anti-money laundering legislation; and
- auto-enrolment (AE).

Box 5.B: Small business adviser

"Over the lasts twenty years we have seen a similar story of increased complication and unnecessary tinkering with the system. This has a number of detrimental effects on our members, firstly it makes it harder for them to plan effectively without bringing in tax specialist and more importantly it has considerable demotivating impact on the business owner"[2]

5.7 AE was simply seen by many as a tax on employment. Arising out of the Lord Carter of Coles Review of HMRC Online Services[3] the last decade has seen a drive to mandate business to report on line. The mandatory requirement to file VAT returns on-line was followed shortly afterwards by the same in respect of Corporation Tax (CT) returns with their statutory accounts information tagged using (iXBRL)[4] and latterly the filing of payroll returns under real time information (RTI). This trend it is set to continue for the rest of the current decade with the continuation of the AE rollout and then on into the future taking into account the recently published MTD roadmap.[5]

5.8 Although owners are largely supportive of the move to digital, it has not been without a significant preparation cost; software suppliers have spent a considerable proportion of their development budgets meeting governmental departments' compliance requirements during this period rather than provided added value enhancements to their software.

5.9 The feeling amongst stakeholders is most of the mandated online filing has been of little perceived benefit to those affected, with more in it for government than for small business.

HMRC support to companies

5.10 HMRC's recent poor helpline performance was seen as a problem by all concerned[6]. Owners have little spare time and are unable to hang on for the duration while held in a call-centre queue. Many cited this fact as one reason that agents were considered to be an invaluable tool. Their engagement enabled small company owners to focus on the more pressing day to day issues affecting their business.

5.11 The OTS acknowledges that HMRC has committed £45 million and recruited an additional 3,000 staff [7]and expects that owners will see an improvement in call centre performance as the additional resource comes on line.

5.12 HMRC's Agent Dedicated Line (ADL) stood out as beacon-of good performance, its performance did not discernibly slip. In recognition of the excellence of the ADL service agents called for similar dedicated lines to be set up for the other main heads of duty (PAYE, VAT and CT).

5.13 Uncertainty was seen as a real issue for owners and given as further justification for their need for agents. Many small company owners were concerned that they were unable to make

[2] Small Business Taxation Review January 2016 Forum of Private Business
[3] http://webarchive.nationalarchives.gov.uk/20060719043117/http:/www.hmrc.gov.uk/budget2006/carter-review.pdf
[4] https://www.gov.uk/government/publications/xbrl-tagging-when-what-and-how-to-tag
[5] https://www.gov.uk/government/publications/making-tax-digital
[6] http://www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news-parliament-2015/hmrc-performance-report-published-15-16/
[7] https://www.gov.uk/government/news/hmrc-acts-to-improve-customer-service

contact with HMRC with respect to technical matters, or if they did they could not get the level of technical help, and stated that an inability to get advance clearance hampered their ability to make investment decisions.

5.14 There is a clear need, in what is a self-assessment regime, for owners seeking to be compliant to have access to a means of gaining advance clearance in respect of complex transactions in order to afford them a level of certainty when making business decisions with tax implications.

5.15 The requirement for a multi-channel one-stop-shop call centre approach, whereby callers speak to single person about a range of technical and non-technical issues was a recurring theme. It was felt the provision of such a service would mitigate against the 'silo-structure' of HMRC's businesses streams that result in taxpayers having to interact with HMRC across many heads of duty.

5.16 We were told that it would be simpler for companies to be able to make a single email notification to HMRC when any one company address changes. At present, notification needs to be made for PAYE when the payroll operator address changes, a separate notification for VAT is necessary when the business address changes and Companies House need to be informed to enable CT records to be changed. We suggest this could be made possible by a structured email to selected heads of duty when an address changes.

5.17 **The OTS recommends that HMRC gives consideration to the provision of a one-stop-shop call-centre as it fits with HMRC transformation of services[8] and also enable small companies (and other taxpayers) to engage with the department in a way that suits their business rather having to engage in a way that suits the department. This is in effect part of what HMRC are aiming for with their 'Once and Done' way of working.**

5.18 **At the same time the OTS considers that thought should be given to involving Companies House in respect of the work arising out of our recommendation made in 5.17 (above).**

5.19 A small number of owners raised concerned about receiving inconsistent advice and stated that delays in receiving call-backs were an issue.

5.20 In the wake of the closure of local enquiry centres and the recently announced move to regional processing[9] a need was expressed for HMRC to still maintain a local presence through the running of targeted roadshows, or via local interest-groups such as chambers of commerce covering topical areas of tax that would be beneficial to owners. We think this expressed need has merit and recommend that HMRC should take it into account in their future planning of for taxpayer engagement.

5.21 The lack of a Customer Relationship Manager (CRM) was seen to be an issue affecting small companies. While it is not expected that HMRC could, or should, resource customer support to a level of providing CRM's for small companies, some of the need for such a service can be relieved through taxpayer and agent online self-service (AOSS[10]) facilities that it is anticipated will be rolled out in the future.

Agents of small companies

5.22 An inability to access HMRC backend systems to the same degree as taxpayers means agents are hampered in performing vital activities, such as viewing liabilities and payments.

[8] https://www.gov.uk/government/speeches/building-our-future-transforming-how-hmrc-serves-the-uk
[9] https://www.gov.uk/government/news/hmrc-announces-next-step-in-its-ten-year-modernisation-programme-to-become-a-tax-authority-fit-for-the-future
[10] https://www.gov.uk/guidance/agents-new-online-services

This, agents told the OTS, resulted in increased administration costs arising out of inefficiencies being borne by all parties in the relationship, including HMRC.

5.23 Agents were particularly concerned over their experience of contacting the Employer Helpline, the line that deals with PAYE related queries. Protracted wait times and non-relevant in-call messages were a source of frustration for agents. Agents understandably want to talk to an expert when dealing with a client issue rather than a general call handler and the Agent Dedicated Lines (ADLs) generally do this well. Ideally the one-stop model suggested for businesses would be available for agents but that may not be practical. **But in order to reduce the cost born by small companies through their agents arising out of protracted queuing, the OTS recommends that HMRC undertake a feasibility study into the possibility of expanding the current number of heads of duty covered by its ADLs service.**

5.24 Online agent authorisation was considered to be more problematic than the traditional paper-based version. An online request for authorisation intended to cover more than one area of tax results in separate authorisation codes being issued for each head of duty being sent to the taxpayer, who in turn has to deliver each to their nominated agent. Whereas the traditional authorisation could be completed to take into account almost all areas of taxation, signed by a taxpayer and then submitted to HMRC to process and give the appointed agent immediate on-line access to their client's records.

5.25 The inability of the current agent authorisation system to recognise more than one agent acting on behalf of a taxpayer in respect of different areas of tax was said to cause problems. The OTS is aware of work within HMRC arising out of their roll-out of Agent Online Self-Serve[11] that should address the areas of agent registration outlined in the preceding two paragraphs. We therefore make no recommendation beyond encouraging the rollout of the Agent Online plans.

Companies House vs HMRC

5.26 Dealing with Companies House was seen to be simpler and easier than with HMRC. Those who contacted the former did not experience any significant waiting time in a call-centre queue.

5.27 The profusion of filing and payment deadlines in respect of companies' accounts, annual returns, payment of CT and the filing of the CT return was seen by many to be an unnecessary complication. The OTS recommends that HMRC and Companies House consult jointly with the view to establishing a cross-department common filing and payment deadline date.

Box 5.C: Small business adviser

"The administration burden imposed on small business is substantial and compounded by Companies House compliance requirements"

5.28 The most popular simplification-requests under this heading was in respect of a joint registration service for companies along the lines of the 'Tell us once' service[12] (TUO), whereby a person can inform almost all government departments in one action by going on line in the case of a bereavement. As the system currently exists, on incorporation, owners have to engage separately with Companies House and HMRC. (And even more frustratingly they have to contact various departments within HMRC in order establish a payroll and register for VAT (as applicable). This is seen by many to administratively cumbersome.) (See *Lifecycle* chapter)

[11] https://www.gov.uk/guidance/agents-new-online-services

[12] https://www.gov.uk/after-a-death/organisations-you-need-to-contact-and-tell-us-once

5.29 The OTS is, also, aware of work within HMRC in respect of a master customer record (MCR), which will assign a unique reference to a taxpaying entity in order to enable all of its information, across the various heads of duty, to be seen, or accessed, in once place as well enable that entity to make all its intervention in one place.

5.30 **It is our recommendation that HMRC ensures that due consideration of owners' requirement for a single registration process is taken into account in their work on the MCR. It should be noted that an important feature of single point of contact should be that it should be accessible using a unique reference number issued at the time of the formation of a new company. (See *Lifecycle* chapter)**

Corporation tax

5.31 The completion and filing of a CT return was not seen as particularly onerous by those consulted as they saw it was something that was dealt with by their accountant at the time of their preparing the year end accounts. Agents stated that the need to file accounts that had been iXBRL[13] tagged was problematic, in that it was time consuming, laborious and of no tangible benefit to those filing.

5.32 During discussions with stakeholders a level of frustration was expressed over the lack of access for agents to the recently launched Companies House and HMRC joint statutory accounts and tax return filing software (CATO). CATO filing was not considered to be a very good process as it did not seem to be true joint filing, through a requirement for certain elements of data needing entering twice. **The OTS recommends that, if HMRC does not wish to reverse its policy decision regarding the availability of CATO, it collates and subsequently curates an online list of low-cost third-party software that agents could subscribe in order to meet the mandatory on-line filing requirements.**

5.33 Some 325,000 businesses use the joint Companies House and HMRC free online software to prepare and submit their Companies House accounts, and CT returns. We have seen that although described as joint, the software takes users through the Companies House basic micro entity requirements first, and then repeats the requirements in more detail for corporation tax, as full profit and loss account and tax adjustments are necessary here.

5.34 Additionally the OTS recommends that HMRC and Companies House review the current working of CATO with the view to reducing the requirement for its users to enter data twice. One way that this could be achieved is by ensuring that the minimal data required in order to lodge small companies' statutory accounts with Companies House is retained for use when inputting the more detailed information required by HMRC when filing a set of accounts, CT return and supporting computations to them.

Nil returns

5.35 A recurring theme amongst owners and their representatives was the administratively burdensome requirement currently imposed on owners to either file "nil" returns, or to claim exemptions when government departments already hold sufficient information to grant an exemption. The requirement to file "nil" returns in respect of the Annual Tax on Enveloped Dwellings[14] (ATED) was repeatedly given as an example of unnecessary administration.

5.36 While it was generally understood and accepted that HMRC needed to be aware of those potentially within scope of ATED a possible way to address the admin burden associated with the preparation and submission of a nil-return would be to enable such entities to claim a

[13] https://www.gov.uk/government/publications/xbrl-tagging-when-what-and-how-to-tag
[14] https://www.gov.uk/guidance/annual-tax-on-enveloped-dwellings-the-basics

dispensation from the need to file annual ATED returns, renewable every five years or which cease to be valid on a relevant change in circumstances.

5.37 A further suggestion that could be beneficial, both for the taxpayer and the affected local authorities was in respect of an automatic exemption, or reduction, in liability to pay non-domestic rates (NDR) for owners who only occupy one property and its rateable value is below £12,000, rather than a requirement for the owner to make a claim as now.

5.38 The OTS is aware that a review of Business Rates is underway and we will pass our findings to the relevant review-team.

5.39 **With a view to a quick win, the OTS recommends that HMRC gives consideration and enters into discussions with those affected to establish the feasibility of introducing of a process to claim a dispensation from the requirement to file nil ATED returns.**

Research & development tax credit

5.40 The research & development (R&D) tax credit claims process was considered onerous by a number of stakeholders and as a deterrent to making claims.

Box 5.D: Small company owner

"It has always looked like too heavy an admin load to be really worth taking on, even though much of my work would count."

5.41 The OTS was informed that many small company owners are so involved in the day to day running of their business that they cannot spare the time to undertake the work required to prepare a claim, even to the extent that they felt unable to engaged in preparatory work to a stage whereby their accountants could make a claim on their behalf.

5.42 Of concern to the OTS is that, as an unintended consequence of this area of government policy, there is a proliferation of "specialists" charging up-front fees of up to 30% to make the claims on behalf of owners. If the claims process was simple and easy for claimants to engage with, this industry would see a much reduced reason to exist.

5.43 While not affecting the same number of those consulted as the R&D tax credit claim, but still of significance, the Enterprise Investment Scheme (EIS) claims process was also seen as administratively overly complex. One practical suggestion made to assist would-be claimants noted by the OTS was a request for the design and provision of on-line claim-templates, with inbuilt check boxes in order to guide the compiler through the claims process.

5.44 It emerged through our stakeholder engagement that a lack of understanding of the claims-process acted as a significant brake on the take up of R & D tax credit. A point that had previously been covered by the OTS in its UK Competitiveness[15] report published October 2014, where the following suggestion was made[16]:

[15]https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/362302/competitiveness_review_final_report.pdf
[16] OTS UK Competitiveness report, Page 37

Box 5.E: OTS UK Competitiveness Report

"The official guidance would benefit from more examples and case studies of successful claims.

This should include more guidance on software, where it can be particularly difficult to draw the line between qualifying and non-qualifying activity. The HMRC team in Cardiff said that around one half of the claims they receive relate to software.

There is scope for better guidance on what costs do and do not qualify. Most business say that they can manage the costs that qualify for R & D easily once they know what qualifies, and the R&D teams report few issues with established business. The main certainties seem to be around HR costs."

5.45 In response to our UK Competitiveness report suggestions, HMRC undertook to produce more case studies for inclusion into their guidance and to give clearance guidance on what capital/revenue expenditure for software.

5.46 **The OTS recommends that HMRC engage with interested parties in order to establish if its additional case studies and guidance has met the OTS's earlier report's objectives; and at the same time to establish if there is scope for further simplification in order to foster greater take up and to empower owners to make their own on-line credit claims rather than have to rely on third party support, which on occasions can be charged at an inflated price.**

Flat rate allowance

5.47 The introduction of Flat Rate Allowances (FRAs), similar to those in place for employees[17] and unincorporated business[18] (in the case of business use of domestic premises and motor vehicles) was put forward by a number of those consulted as being a quick-win simplification measure.

5.48 The following are examples of suggested expenses that could claimable by a FRA:

- The use of domestic premises for businesses purposes;
- Facilities used for business purposes i.e. washing machine, domestic ovens and fridges; and
- Use of a home phone, broadband or a private mobile phone of business purposes.

5.49 The OTS believes that there is considerable scope to build on existing flat rate allowances and introduce further flat rate allowances, and we recommend consultation to this effect. At the same time, we recognise the potential problem in ensuring the amounts involved are realistic and kept up to date. This may help with MTD compliance.

VAT

5.50 VAT was seen by many to be an overly complex area of taxation which is hampered by the fact that there was, largely, an absence of an advance clearance facility. This was highlighted in the OTS's Competitiveness report and our recommendation for wider use of clearances was directed particularly at helping smaller businesses.

[17] http://www.hmrc.gov.uk/manuals/eimanual/EIM32712.htm
[18] https://www.gov.uk/simpler-income-tax-simplified-expenses/working-from-home

5.51 The new EU sales rules and the Mini One Stop Shop (MOSS) requirements, which came into effect in January 2015 and which are concerned with VAT due on sales of digital services to consumers in the EU presented significant administrative problem.

5.52 The two key issues identified in respect to the operation of MOSS, are:

- Firstly, prior to January 2015 a UK VAT registered business merely entered into a transaction with a non-UK customer and levied VAT at the UK rate on the transaction. The record keeping required was minimal.

  Post 1 January 2015 for cross border supplies of digital services there is no registration threshold and VAT has be charged at the rate due in the consumer's country. As a result the administrative burden imposed on UK business has increased significantly.

  Many small companies were required to redesign then websites in order to gather the extra data required in order to identify the place of supply (where the consumer was located), so that VAT at the rate applicable in the consumer's EU country of residence is levied on the electronic transaction.

- Secondly, due to the fact that there is an absence of a registration threshold even non-VAT registered VAT UK traders making cross-border supplies of digital services are required to register for MOSS and levy VAT at the rate applicable in the consumer's EU country of residence.

5.53 In a similar vein to the operation of MOSS cross-border VAT was seen to be overly complex. The main issue identified were:

- Prevailing legislation was enacted in a time when cross-border trading was the preserve of a few; and
- Other EU countries were unwilling to raise their registration thresholds meant that UK companies were having to register in the EU states concerned.

5.54 A number of those consulted recommended that to counter the low registration thresholds existing in many other EU countries the UK should give serious consideration to reducing its own threshold, as discussed elsewhere in this report.

5.55 The OTS is aware of a recent easement introduced by HMRC in January 2016[19] whereby UK micro-businesses that are below the current UK VAT registration threshold and are registered for the VAT MOSS, may now use best judgment and base their 'customer location' VAT taxation and accounting decisions on a single piece of information, such as the billing address provided by the customer or information provided to them by their payment service provider. While acknowledging this action as a simplification measure we are concerned by its subjectivity.

5.56 Overall, the OTS recommends HMRC:

- Evaluates the feasibility of the establishment of an advance-clearance facility in respect for VAT registered traders, in line with the OTS's previous recommendations.[20]
- Engages in consultation with the Joint VAT Consultative Committee[21] over cross-border digital-trading, in a post implementation review of MOSS in order to

[19] https://www.gov.uk/government/publications/vat-supplying-digital-services-to-private-consumers
[20] The OTS UK Competitiveness Report chapter 4.
[21] https://www.gov.uk/government/groups/joint-vat-consultative-committee-jvcc

establish what opportunities there might be to reduce the administrative burden that compliance with the change in accounting for VAT has imposed.

- Engages in consultation with cross-border traders to establish whether current cross-border regulations are still fit for purpose in the modern era.
- Improves signposting of the availability of the Flat-rate scheme, to address the awareness issue raised in the Structure of Company Tax chapter.

Pay As You Earn (PAYE)

5.57 The rigidity of the current system for employers to make payment of PAYE deductions to HMRC was of concern to small companies. Some employers do not like the fact that they encounter problems with the timing of filing returns and making payment that result in their waiting until after the 5th of the month following the PAYE month in which wage payments were made, in order to make payment of the tax and national insurance withheld to HMRC.

5.58 From an administrative perspective, some employers wanted to have the ability to pay over the PAYE deduction to HMRC at the same time as paying their employees, but are unable to do this at present. Others wanted to have the opportunity PAYE deductions to be collected by direct debit in much the same way as their liability to pay VAT over to HMRC. The requirement to submit "nil" RTI returns when wages are not paid was a nuisance. (However, it was acknowledged from an operational perspective that without the receipt of such returns HMRC would not know whether or not payroll had been run.)

5.59 The fact that VAT and PAYE have different filing and payments dates was thought to be problematic. Some stakeholders considered that a common payment date would be helpful to them in the operation of their businesses.

5.60 OTS recommends that HMRC evaluates the potential to re-engineer existing systems to make settlement of the tax and NI more customer-focused. If achievable, this would have the benefit to the department of either accelerating the timing of collection or helping to ensure that payment is made promptly.

Others areas

5.61 While the above were the most commonly cited areas requiring administrative simplification a number of other practical suggestions were made to the OTS and which were considered to be of note:

Structured forms

5.62 Various areas of frustration were identified in respect HMRC's interactive on-line, or pdf-type, forms surfaced during stakeholder engagement, the main remedies for the concerns are as follows:

- When completing on-line forms users should be free to move between pages unless all fields on the current page had been completed; and
- Users should be enabled to save completed forms, or return to partially completed forms.

5.63 The OTS is aware of ongoing work within HMRC in respect of the design and provision of i-forms and recommends that the department takes into consideration the above customer requirements.

Track-and-trace

5.64 A track-and-trace facility whereby agents/taxpayers are able to logon to HMRC's system of post on-hand rather like that offered by Amazon would be beneficial. The introduction of time-to-pay was cited as a boon to business. The OTS is aware of ongoing work within HMRC in respect of the design and provision of track-and-trace facilities.

Making Tax Digital (MTD)

5.65 The OTS is charged with giving independent advice to government in respect of the potential to remove areas of complexity in the current UK tax system and therefore tends to deal only with existing law and practice. The autumn 2015 announcements setting out at a high level HMRC's bold vision of their proposal to digitally transform the UK tax system by 2020 are of such major significance that the OTS considers to ignore the design and implementation of MTD would be an opportunity lost:

a) In respect of working with HMRC to avoid areas of complexity in the current system just being replicated in the new digital system; and

b) Assisting HMRC in minimising the inadvertent inclusion of new complexity into MTD.

5.66 At the launch of the MTD document HMRC announced that it would be consulting on the design and implementation MTD from early in 2016. Most of the observations garnered during the evidence gathering stage of the preparation of this report are based on individuals' assumptions made in the absence of detailed information.

5.67 MTD's launch came midway through OTS's period of evidence gathering and so as a consequence not all those consulted had the opportunity to comment. The stakeholders consulted mostly welcomed the proposed move to digitisation, saying that they saw it as the way forward. Concerns were expressed, however, over the proposal to mandate taxpayers to report on-line on a quarterly basis using apps and third-party-software for a number of reasons, for example:

- Not all areas, particularly remote rural areas, have robust broadband connectivity.
- The apparent requirement for taxpayers to file simplified reports of income and expenditure was an increase in the administration burden.
- If the government proposed simplified accounting, it might be fine but what about stock and work-in-progress
- HMRC does not seem to understand small business and it appears that they are attempting impose the discipline of larger businesses on to them.
- Concerned over what is perceived to be a one size fits all approach.
- The implementation time scales are so tight that HMRC runs a significant risk of failure to deliver on time.
- At this stage the implication of the proposals did not feel like they had been fully thought through.
- The benefits accruing from a successful implementation of MTD seem to be largely in HMRC's favour.
- It is unlikely that software houses been sufficiently engaged to ensure that their apps and software will be ready to meet the online filing requirements

- It is not right for government to impose a requirement to use third party software on business
- If payments of tax due is moved to an in-year quarterly basis it could give rise to credit problems and also have significant cash flow implications during the transition stages
- Quarterly reporting is likely to require business to spend a disproportionate amount of time on MTD compliance.
- Quarterly reporting could be particularly problematic for the likes of farmers with their profit averaging, or businesses subject to seasonal variations in their income and expenditure.
- Businesses whose owners regularly worked outside of the UK might struggle to comply with quarterly reporting.
- Businesses who have been totally happy until now using a spreadsheet to report do not see why they should move to using third party software, incurring additional costs in the process.

5.68 As previously observed, those consulted were not averse to the move to digital but in general they were concerned over the proposal to mandate quarterly reporting. If the government intends to introduce a simplified quarterly reporting process with a possible need for a final reconciliation submission, they could not see that it would be anything other than more time consuming and costly to comply with. A selection of contributors put forward an alternative proposal of regular in-year payments on account toward and expected end of-year tax liability and then filing online after the end of year with a possible final tidy-up payment.

5.69 Many welcomed the welcomed HMRC's API strategy[22] saying that the proposed pre-population of third party-software and apps with information held by HMRC was a significant and positive step.

5.70 Agents told OTS that in order for MTD to work efficiently, they must be able to access the same HMRC information as taxpayers. Furthermore, agents and taxpayers alike must be able to see details of all taxes in once place, with a facility that would enable them to allocated payments as they consider appropriate.

5.71 It was also suggested that, if a cash-basis of reporting was permissible and reportable taxable profits were more closely aligned to the accounting profits, then any in-year reporting process would result in a lower administrative burden.

5.72 HMRC will no doubt have heard many similar comments to those that OTS heard. Despite the concerns expressed to us, we reiterate the general point that there is support for the direction of travel. This is something that OTS endorses as it gives great scope for simplification. We recommend that the OTS is formally involved with the design and implementation stages of MTD to ensure that simplification issues are fully considered.

[22] https://www.gov.uk/government/news/hmrc-launches-ambitious-api-strategy

6 Lifecycle of a small company

Company start up

6.1 Limited companies can be set up in a variety of forms, the two main forms being those limited by shares and those limited by guarantee. For the purposes of our report we will ignore unlimited companies and public limited companies as being outside of our Terms of Reference.[1] The differences lie in whether the owners of the business own shares in the company (in which case it is limited by share capital) or whether they simply guarantee a contribution should the company run out of funds and become insolvent. In the latter case, the company is said to be limited by guarantee.

6.2 Commercial companies are invariably limited by share capital as this provides a vehicle to pay out excess profits to the owners by way of a dividend. Limited by guarantee companies are usually not-for-profit organisations where no such mechanism is required and therefore they do not feature in this report.

6.3 There is also a particular variation, the community interest company (CIC), which provides a halfway house between the two other main types. It is aimed at organisations such as sports clubs and community ventures that may combine the two attributes of a commercial business and a not-for-profit organisation such that there is an "Asset lock" and a limit on the level of any dividends that can be paid out. This type of company is also outside of the scope of this report which will continue concentrating on incorporated businesses limited by share capital.

6.4 Once the decision has been made to trade via the structure of a limited company the first consideration is the formation of the company which is a separate legal entity from that of its shareholders (owners).

6.5 The formation can be undertaken either online via Companies House (and the single government domain project)[2] or with the help of a company formation agent (with or without the assistance of an accountant or tax adviser). It is still possible to incorporate using paper forms but only approximately 1% of incorporations are made this way.

6.6 Of the 99% who incorporate online, approximately a third use the Companies House website with two-thirds using third parties.[3]

6.7 The cost of this varies from £15, if it is done via Companies House[4] (this is simply the fee to file the paperwork), to anything from £30 to several hundred pounds if done via agents. In the latter case the cost depends on whether the documentation is standard or bespoke, whether there are different classes of shares and whether the business-former decides to complete the paperwork (such as shareholder and director registers) himself or with the assistance of an agent. Some formation agents offer a very basic paperless incorporation service for as little as

[1] www.gov.uk/government/publications/ots-review-of-small-company-taxation-tor
[2] www.gov.uk/register-a-company-online
[3] www.gov.uk/government/statistics/companies-register-activities-statistical-release-20142015 2014/15 98.7% incorporated on-line. In the period 1 April 2015 to 31 December 2015 162,723 of 439,273 incorporations used Companies House website per Companies House
[4] www.gov.uk/register-a-company-online

£12, with varying levels of professional assistance. The basic service provided via Companies House is probably sufficient for most "nano" businesses.[5]

6.8 The simplicity with which a company can be formed online via Companies House was a matter of comment by our respondents. It was considered by many that the complexity was "about right", although a significant minority were concerned that those choosing to create companies without professional assistance could do so without realising the implications of their actions. Examples were given of:

- new companies created with excessive share capital;
- a lack of appreciation of the duties and legal responsibilities of shareholders and directors;
- incorporation at too early a stage in a business' evolution;
- Several respondents considered that some companies were formed "by accident" on the false understanding that this was the only available way to set up in business.

6.9 There was wide agreement that more education was a sensible way to reduce this without stifling entrepreneurial spirit and without a detrimental effect on the UK's standing in the World Bank's annual "Ease of Doing Business" ranking.[6] There was also the suggestion that this education should begin at school and only suitably qualified persons should be able to become directors of a company.

6.10 Many respondents suggested that the incorporation tools online should include more assistance and **we would recommend that additional pop-up boxes are added with suitable information (Stop/Think questions where necessary), users are required to affirm their positive understanding of difficult areas such as share capital via "tick-boxes" and there is a Yes/No question specifically around professional support to encourage those who need additional help or are unsure to seek appropriate advice.**

6.11 There was some support for a "cooling-off" period when choices could be altered for a limited time after completing the online application. Perhaps the company former could be sent an e-mail setting out what has been proposed with the need for a confirmatory response before events are set in place. We understand that in Germany company formation can only take place via agents who carry out background money laundering (ML) checks as part of the process. **Whilst not wanting to restrict the process in this way we recommend that basic ML checks are built into the system to enhance the process and help reduce fraudulent company formations.**

6.12 The registration of a new company prompts HMRC to contact the new business with a form CT41G, which asks for information about the company including its trading status (whether it is currently trading or is simply dormant with the name having been registered). The business owner is prompted to register on-line for the various taxes (CT, VAT and PAYE in particular) that may be appropriate.

6.13 As appropriate, authorisation codes are then issued and the taxpayer can then commence to set up access to the Government Gateway to review and submit details concerning the various taxes dealt with by HMRC (usually corporation tax, VAT and payroll taxes).

[5] A company with one or two shareholder-directors and zero employees

[6] www.doingbusiness.org/rankings

6.14 Respondents found this to be a frustrating experience with too much repetition and **we recommend that the system is changed so that information for government agencies (primarily HMRC and Companies House) are needed to be entered on-line only once.**

6.15 The OTS is aware that in response to a statutory[7] requirement HMRC is currently working with Companies House in order to design and deliver a streamlined company registration process which is expected to go live in May 2017. From that time users will be able to form a limited company and set up the three main taxes (CT, VAT and PAYE) via a single web-portal. It is expected that the ability to register for other taxes will follow.

6.16 From June 2016 the Annual Return is due to be replaced with a "Confirmation Statement"[8]. This will need to be completed by the company at any time, provided that a statement is completed at least once every 12 months. This may address some of the issues of duplication of returns, as this could be completed at the same time as accounts are filed and the OTS commend this as an example of adapting the filing requirements to suit the end-user.

Incorporating an existing business

6.17 An unincorporated business that is currently trading (and is solvent) may decide to convert from a sole trader or partnership to the status of a limited company. There are many motives for doing this. These range from simply to benefit from the limited liability that incorporation offers, to benefit from a different tax regime than as a sole trader or partner (a taxation motivated incorporation or TMI), or it may be a requirement of continuing to trade with customers or suppliers, a desire to expand the ownership of the business or to give the business added status, or a combination of some or all of these.

6.18 As in the case of a new business, it is necessary to initially set up a limited company to act as the recipient of the assets and trade of the existing unincorporated business and the administrative process will be identical to that discussed above.

6.19 A key difference and potential complication is that the existing business will have assets and liabilities generated whilst it was unincorporated and some or all of these will need to be transferred to the newly incorporated vehicle.

6.20 A fundamental concept, which we have been advised is often misunderstood, is that a company is a separate legal entity from its shareholders. As the transfer is between two different legal entities, there are legal consequences which need to be reflected in the paperwork accompanying the transfer.

6.21 In practice this is an area that can sometimes be done incorrectly and/or sometimes even ignored entirely. From a procedural point of view there should be a contract transferring the chosen assets to the company, identifying what is being transferred and at what value, even if at that precise point (until final accounts are prepared) the exact figure may be missing.

6.22 There also needs to be a decision as to the manner in which the transfer is to be effected – are the net assets being transferred in exchange for shares or are they being transferred in exchange for a loan from the previous owner(s) or a combination of the two? Are some or all of the net assets being gifted to the new company? These different routes to transferring the asset have different tax implications.

[7] Small Business Enterprise and Employment Act 2015

[8] www.gov.uk/government/news/the-small-business-enterprise-and-employment-bill-is-coming

6.23 There will be a cessation of the sole trader or partnership with the consequential cessation income tax calculations. In addition, decisions will need to be made concerning transfer values on any assets being transferred that are subject to capital allowances.

6.24 There may also be a transfer of goodwill created by the previous business which is being sold or transferred to the company taking over the business. This will need to be identified and valued as well as a decision made on how this is being paid for, whether by cash, credit or share capital. These transfers can give rise to income tax receipts (for example capital assets transferred at more than their written down value) or capital gains tax on, for example, the goodwill now in the hands of the company.

6.25 In order to aid this transition there are a number of specific taxation provisions aimed at deferring tax charges and therefore liabilities to a future point. In particular s.165 TCGA 1992 allows assets to be transferred to the company at an under value with the ensuing gain held over into the company.9 The other provision which can be used is s.162 TCGA 1992 which allows assets transferred into the company to be exchanged for shares in the company, with the gain over the current value of those assets to be deferred so the effective base cost for CGT purposes equals the initial value of the shares. When the shares are sold the original gain is restored against the nominal value so there is a capital gain on the owner at that point.10

6.26 In practical terms much of the above may not be relevant to nano-businesses that do not have significant assets that appreciate and goodwill which may be personal to the sole trader and therefore cannot be separately transferred. It is probably unlikely that such businesses would attempt incorporation without the help of a professional adviser unless the incorporation was effectively equivalent to starting a completely new business from scratch.

6.27 **We recommend that, where a company is formed online via Companies House there is a specific question checking if the reason for the formation is to transfer a business. If so, additional positive affirmation by tick-box should be required around these issues with a suggestion professional advice is obtained if there is any doubt.**

6.28 Particular care is necessary where a business has previously been carried out in an unincorporated structure and is then transferred to a corporate one. Transferring to a company can be complex and there are administrative issues around the changing of name, opening new bank accounts and having to comply with accounting standards that are more rigorous than before. Customers of the unincorporated business transferring to the new limited company need to appreciate that this is a different entity and particular care is needed to ensure that payments they make are reflected in the correct business and bank account. A particularly interesting comment was "Often a business which starts as a company is able to better cope with tax and administrative issues than a business initially operated as a sole trader who has later incorporated." For owners who have been used to the ability to blend private and business matters via an unincorporated structure the additional rigour of a corporate body takes getting used to. Additional advice via prompts could be targeted to these situations.

Exiting a company

6.29 As highlighted above, one of the concepts that is often misunderstood is the fact that the company that often is "theirs" or at least owned by their close family, is, in fact, a different legal entity and transfer of assets outside of this entity have legal and tax consequences. This sometimes only becomes apparent if funds have been withdrawn from the business in excess of

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[9] www.hmrc.gov.uk/manuals/cgmanual/cg669

[10] www.hmrc.cov.co.uk/manuals/cgmanual/cg657

profits generated, or without being accounted for as payroll, loan or dividend as appropriate. When these transactions are properly accounted for, often some time after the event, no consideration has been given to the tax liability generated and payable.

6.30 Another occasion where this is relevant is when there is an exit of some type from the company, for example, by sale, death, liquidation or disincorporation.

Sale of a company

6.31 There are contrasting taxation consequences on the sale of a business which trades as an incorporated company. In general there has to be a decision whether to sell either the trade out of the company (in which case it is the company that has made the disposal and receives the proceeds) or the shareholder(s) sell their shares which gives rise to a capital gain personally (the company continues to trade but under different ownership).

6.32 There may be pressures on the seller from the buyer. The new owners may want to hold the business trade in a different (possibly new) company or, alternatively, wish to own the existing shares in the current company. The existing shares carry with them any possible misdemeanours or problems from the time of the previous owner(s). This risk can sometimes be covered in the details of the share transfer deed.

6.33 From the seller's point of view, if he sells the trade and assets out of the company then the company will make the disposal and pay corporation tax (currently at 20%) on any capital gain. The company will then receive the cash which will need to be transferred out of the company (with the tax implications that this holds for dividends, bonuses or capital distributions) in order for the owner(s) to be able to use the proceeds privately.

6.34 If the seller disposes of his shares then the proceeds are his at that point and there is a Capital Gain computation to be made on any gains he has made on his shares. Any ensuing capital gain may then be subject to entrepreneur's Relief (ER) which charges the gain (after any annual exempt amount) up to £10million at a current rate of 10% rather than the rates of 18% and 28% which apply to other taxable capital gains.

6.35 Entrepreneur's Relief attracted some comment from respondents. Some considered it a distortion to the tax system and doubted whether it encouraged entrepreneurs.

Inheritance

6.36 On the death of a shareholder, the shares become part of the assets of his/her estate and pass in line with that estate – often via a will. The company continues but the owners, who are a different legal entity, change as do the recipients of dividends on the underlying shares. The new owner(s) may get involved with the company and become directors.

6.37 Potentially the shares might be liable to inheritance tax although in the vast majority of cases they will be fully exempted by business property relief (BPR) and pass to the next generation undiminished by a tax charge.

6.38 It was commented that the system often generates an unnecessary cost for a valuation of shares when they would be 100% exempted by BPR.

6.39 A further suggestion we heard was that consideration should be given to BPR relief on director's loan balances. These loans are often given to assist with inward investment in the business. Any additional tax cost might be covered by adjusting the amount of BPR available. Perhaps £10million might be relieved at 100%, with additional assets over this amount charged to perhaps 50%. This would provide additional assistance to the majority of businesses whilst

generating a tax charge for businesses with the most valuable assets whilst being tax neutral over all. This is an area that might be a suitable for a review by the OTS in the future, probably as part of a wider review into IHT reliefs. Without such an overall review we cannot make a formal recommendation on the point, but note it for future consideration.

Disincorporation

6.40 Should it be decided that the company should come to an end and there are assets left (in effect a solvent disincorporation), then there is the necessity for some form of disincorporation. Before 1 March 2012 the commonest way of achieving this was to take advantage of Extra-Statutory Concession (ESC) C16, which enabled application to be made to HMRC for the final distribution from the company to be treated as a capital event so for all practical terms the treatment was as though the shares of the company were sold for the net asset value of the company. Capital gains tax was then payable on the gain over (usually) the initial value of the shares. Reliefs such as ER were available so that the gains on this transaction were often covered by the individual's annual exempt amount with the balance taxed at 10% via ER.

6.41 Since the withdrawal of ESC C16 from 1 March 2012, the capital treatment has been restricted to companies where the distribution is no more than £25,000. If this is not applicable, then the only alternative is to seek a formal solvent liquidation with the ensuing cost (upwards of £2-3,000) and complexity. In other cases the payment out of the assets of the company are treated as an income distribution.

6.42 The government therefore introduced a disincorporation relief which is available for companies with assets (goodwill and land and buildings) of up to £100,000. This is available from 1 April 2013 for five years to 31 March 2018. It allows the qualifying assets of goodwill and land and buildings to be transferred at no gain/no loss.

6.43 There was a general lack of practical experience of this relief. However, most respondents who commented on disincorporation thought that it was inequitable that going into a corporate structure could be tax neutral, whilst coming out of a company could attract a tax charge. Many felt that if the trade continued after disincorporation, perhaps with a minimum required period afterwards, there should be the ability to defer any tax charge. One respondent suggested this be called "General continuity relief".

6.44 We recommend that consideration should be given to this concept as part of the disincorporation relief re-visiting below.

6.45 With the advent of the dividend tax in 2016/17 there is the possibility of a large number of businesses, which incorporated years ago when the taxation system positively encouraged this, wanting to re-form in an unincorporated form but feeling trapped by a changed taxation regime. We recommend re-visiting our original suggestions for disincorporation relief to facilitate this process (see below).

6.46 Once a company has been dis-incorporated then it can be struck off by the Registrar of Companies. The name is no longer shown as a current company in the Register and is then available for future use as necessary.

6.47 A further change recommended in the above OTS Small Business Tax Report was the introduction of a one stop shop process to carry out disincorporation and dissolution of the company by HMRC and Companies House. We continue to hear that notifying separate heads of duty within HMRC and Companies House remains a time consuming issue. Irrespective of any consideration of the disincorporation issue, we repeat our earlier call for a single unit to coordinate this process.

Revisiting disincorporation relief

6.48 In the OTS Small Business Tax Final Report on Disincorporation Relief,[11] published February 2012, evidence obtained suggested a small but significant number of small businesses[12] would like to dis-incorporate, that is to move unincorporated status while continuing to run the business. These companies had found that the additional administration burdens outweighed any tax advantages that applied.

6.49 However, a double tax barrier applies on such a transition, and 20% of agents surveyed by the OTS at that time said that at least 1 in 10 of their incorporated clients would like to disincorporate but cannot, or do not because of the potential tax charges arising at this point.

6.50 The OTS report recommended enabling a company holding goodwill, land and plant, to pass its assets to an unincorporated structure that would continue its activities:

- With no tax charge arising on the company; and
- No distribution charge on the shareholders.

6.51 The relief was proposed for a time limited period of 5 years, with a formal review on whether the relief be made permanent at that time. The proposed relief was aimed at trading companies, and excluded transfer to LLPs, since similar administration burdens would apply which would not satisfy the rationale for the relief.

6.52 HM Treasury launched their own consultation in June 2012, and in December 2012 published their outcome:

- to allow a company to transfer goodwill and an interest in land to its shareholders so that no corporation tax charge on the company arises on the transfer;
- but not extend to relief to tax charges that might arise on the shareholders where, for example, the assets are distributed;
- restrict relief to companies with qualifying assets not exceeding £100,000. Qualifying assets are goodwill and land and buildings used in the business; run for five years from April 2013.

6.53 At the time of writing, less than 50 companies have taken advantage of disincorporation relief.[13] We have repeatedly been told the reason for this is the low asset level test – if any land is held the limit would be almost inevitably be broken, and there are fears goodwill may break the limit, with no pre-transaction clearance available. There is also the absence of relief from the distribution charge on the shareholder.

6.54 The OTS has been told by accounting and taxation bodies that the new dividend taxation rules introduced from April 2016 are likely to increase the number of companies wishing to disincorporate. In the online survey, 24% indicated they would consider disincorporation. We also heard that whilst no tax charge occurs on incorporation, clearly charges still apply on disincorporation, which creates a distortion.

6.55 On the basis of the very low take-up of the relief and the responses received in the process of compiling this report, the OTS endorses the need for the review of the effectiveness of the

[11] ww.gov.uk/government/uploads/system/uploads/attachment_data/file/199181/03_ots_small_business_tax_review_disincorporation_280212.pdf

[12] 14% of companies surveyed stating they would prefer to operate as an unincorporated business - The Futures Company research jointly commissioned the OTS/HMRC

[13] HMRC "less than 50 companies have claimed disincorporation relief" at 4 February 2016

relief. Ideally this would be carried out sooner than 2018. The review should specifically consider whether:

- The relief should also be amended to introduce the shareholder relief contained in the OTS's original recommendations
- The £100,000 limit is working in practice or should be raised
- The relief should be extended to apply to transfers from a limited company to an LLP
- In order for the relief to apply, the continuing business should need to continue for a minimum further period (to be determined)
- The relief should be subject to a review after a further 5 year period

A Terms of reference

OTS REVIEW OF THE TAXATION OF SMALL COMPANIES

Introduction

The Office of Tax Simplification (OTS) has agreed with the Chancellor and Financial Secretary to carry out a project reviewing the taxation of small companies. The overall aim of the project will be to develop recommendations for the Chancellor and Financial Secretary on how to simplify the system, increase certainty and reduce administrative burdens caused by the tax system.

In conducting this review, the office will provide an initial report to the Chancellor by Budget 2016 that:

- examines evidence and identifies the areas of the tax system that cause the most day-to-day complexity and uncertainty for small incorporated businesses
- recommends priority areas for simplification
- considers the impact of any simplification in these areas on other business sectors, particularly small unincorporated businesses

It may publish interim reports or calls for evidence during the review.

Terms of Reference

The review will include, but will not be limited to, consideration of:

- The differing requirements imposed by the tax system on small companies compared with unincorporated businesses (sole traders and partnerships)
- Whether and how tax affects the choice of business form and whether the choices faced by new and existing businesses can be simplified
- Whether there are simpler ways that small incorporated businesses could be taxed, including the potential for a look through basis for taxing small incorporated businesses.
- Simplification of tax policy for companies and how this compares with that for unincorporated businesses, including the relevance of a cash-accounting
- Simplification of administration in the context of HMRC's digital reforms, in particular:
    - Setting up a company when a business starts
    - Carrying out the day to day activities of the business, including record keeping requirements, returns, payments and the tax related choices that must be made by the business.
    - Closing the company when the business ceases
- The distortions between the personal and business tax systems

The government has issued a discussion document on improving the effectiveness of the existing intermediaries' legislation (IR35) which will run in parallel to this review. Accordingly, the OTS review will not specifically consider IR35 but will liaise closely with that work stream.

Further guidance for the review

The familiar term "SME" (small and medium-sized enterprises) is sub-divided into medium (50 to 249 employees), small (10 to 49) and micro (1 to 9). The OTS review will concentrate on micro businesses, but will have regard to small businesses as well[14].
An indication of the significance of taxation to this population is given in the "Small Business Survey 2014" published by BIS in March 2015. This showed that 49% of the micro business population regard taxation as an obstacle to business success and that for the SME population as a whole 11% regard taxation as the main obstacle to business success.

In carrying out its review and developing its recommendations, the OTS should:

- Research widely among all stakeholders
- Involve the members of HMRC's Administrative Burdens Advisory Board
- Aim to build consensus amongst small businesses, tax professionals and academics
- Take into account current and emerging trends amongst small businesses, including the implications of features such as working from the proprietor's home, the growth of exporting amongst small businesses, and an increasing tendency to outsource work to other businesses.
- Consider all taxes and duties that impact on small businesses, including the administrative burdens imposed
- Consider its own previous recommendations on HMRC administration[15] regarding small businesses and how these have been progressed
- Consider the merit of framing reforms on a 'default' basis, such that a simpler basis is the assumed course for taxation but with scope for businesses to opt into a different basis
- Test the impact of the disincorporation relief[3] introduced following a previous OTS report[16]
- Be consistent with the principles for a good tax system, including fairness and efficiency
- Take account of international experience
- Be consistent with the principles and design of HMRCs Making Tax Easier reforms, including digital tax accounts, integrated reporting and payment
- Take account of the interface with other government obligations on small businesses, including BIS regulation such as company registration, reporting and statutory accounting
- Consider revenue implications of individual recommendations

[14] In its previous reports, the OTS coined the term 'nano' business to describe those with turnover under £30,000 (some 2 million in the UK). These are unlikely to be VAT registered and would have none, one or two employees (typically part time).
[15] OTS February 2012, Small Business Tax Review: Final report, HMRC administration Finance Act 2013, section 58
[16] OTS February 2012, Small Business Tax Review: Final report, Disincorporation relief

B Legal issues and alternative structures: The tax system since 1975

These are the changes to legislation that have been made directly or indirectly as a result of the 'agency tax legislation' in 1975.

1975	s.38 Finance (No.2) Act
1978	Social Security (Categorisation of Earners) Regulations for National Insurance
1988	s.134 Income and Corporation Taxes Act 1988 (ICTA) – consolidated s.38 Finance (No.2) Act
1989	Single member limited liability companies made available (Twelfth Council Company Law Directive – The Companies (Single Member Private Limited Companies) Regulations 1992 SI 1699
2000	Intermediaries legislation – IR35 Income Tax (Earnings and Pensions) Act 2003, Part 2, Chapter 8 Finance Act 2000, Schedule 12 Welfare Reform & Pensions Act 1999 Sections 75 & 76 Social Security Contributions (Intermediaries) Regulations 2000 (SI 2000 No.727)
2003	s.44 Income Tax (Earnings and Pensions) Act 2003 (ITEPA) – consolidated s.134 ICTA
2007	Managed Service Company – Social Security Contributions (Managed Service Companies) Regulations 2007 Chapter 9, Part 2, Income Tax (Earnings and Pensions) Act 2003 Chapter 3, Part 11, Section 688A, Income Tax (Earnings and Pensions) Act 2003 – Transfer of Debt provisions Chapter 4, Regulations 97A to 97X, Income Tax (PAYE) Regulations 2003
2007	Construction Industry Scheme – new scheme launched
2007	*Garnett v Jones (re Arctic Systems Ltd)* [2007] STC 1536 – s.619 Income Tax (Trading and Other Income) Act 2005 settlement legislation (income splitting)
2010	Agency Workers Regulations 2010 – draws on s.44 ITEPA 2003
2012	Off Payroll rules
2012	Business Entity Test introduced – (IR35)
2013	IR35 – Officeholders added to legislation
2013	General anti-abuse rule GAAR
2014	Offshore intermediaries' legislation – changes to s.689 ITEPA 2003
2014	House of Lords Select Committee Report on PSCs
2014	Onshore intermediaries' legislation – changes to s.44 ITEPA 2003 – "supervision, direction and control" amendment
2015	Employment Intermediaries reporting requirements – s.84E Income Tax (PAYE) (Amendment No.2) Regulations 2015 – SI 171
2015	IR35 Discussion Document – involving the engager.
2015	Business Entity Test withdrawn - (IR35)
2016	Employment intermediaries and relief for travel and subsistence – s.339A, Chapter 2 of Part 5 of ITEPA 2003
2016	Dividend Tax

C Lessons from other countries

C1. International case studies

Alternative business models

US – Limited liability Company ("LLC")

An LLC a business entity is formed by one or more individuals, as owners. It is a pass-through type of entity, because the profits and losses are passed on to the members depending on their share of membership. In other words, the business income is considered as the owner's or shareholder's income, and the owner/shareholder pays the tax on his or her personal tax return. For a business owner setting up on his own, a *single member LLC* or SMLLC can be established.

Formation

The owners, called "members," file Articles of Organization and set out an Operating Agreement with the relevant state's business division (usually in the office of the state's Secretary of State). A few states also require a certificate of organisation to be filed too. If the LLC intends to do business in other states in needs to register as a foreign LLC with that other state.

Other territories that have similar status

- Since 2006, Japan have had a *godo kaisha (J-LLC).* This is very similar to the US LLC and is also considered to be transparent for tax purposes. However the rules aren't extended to allow a single member to set up a J-LLC
- Mexico has a *Sociedades de Responsabilidad Limitada* or *S de R.L.* providing limited liability to members up to their contribution of capital. It is also considered transparent for tax purposes. Similar to Japan, there is no mechanism to allow a single member S de R.L.
- In Brazil, there is a *sociedade limitada*. A new law in Brazil has made it legal to obtain an LLC by a sole-proprietor called *Empresa Individual de Responsabilidade Limitada* or *Eireli*. Unlike the US, these LLCs are considered to be opaque for tax purposes and so subject to tax at the company level
- In Chile *Sociedad de Responsabilidad Limitada* (Limited Liability Association) is a similar structure to the US LLC. However, they also pay corporate tax on their income, but that amount can be deducted by their owners as a credit against the taxes they pay. Like the SMLLC in the US, there is also special kind of individual owner LLC called *Empresa Individual de Responsabilidad Limitada* or E.I.R.L.
- Colombia has a similar status to Chile
- A number of other countries offer something akin to a US LLC, but they tend to require more than one owner and don't extend the provisions to SMLLCs. The taxation also differs with most considered opaque for tax purposes. These territories include: Denmark and Norway.

France - EIRL

The EIRL status gives limited liability to a business that is not incorporated as a company.

The entrepreneur allocates and declares a certain share of his/her estate to his/her business, so that in the event of financial difficulties or insolvency, creditors will only have access to this 'business estate' and therefore would not be able to seize the entrepreneur's personal assets. The EIRL requires the assistance of an adviser to set up as it requires the fulfilment of a number of formalities.

Formation

There are several filings/publications that are required in respect of the *patrimoine d'affectation* (list of the professional assets which will be allocated to the business). Furthermore, if the value of the estate is more than €30,000, it has to be officially assessed by an accountant or a notary.

The entrepreneur's spouse needs to provide their express agreement if the affected estate includes common belongings.

A look through basis

US – S corporations

Overview of rules

A US corporation may choose to be taxed as an S corporation subject to meeting certain criteria.

Unlike a regular corporation (sometimes referred to as a C corporation) which is taxed at the corporate level as a separate business entity, an S corporation is not subject to corporate tax rates. Instead an S corporation's profits (or net losses) flow through to shareholders based on their respective interest in the business. The profits are then taxed on the shareholder at their marginal income tax rates. This means that regardless of a corporations distribution policy, all profits are treated as if they were distributes to shareholders.

Eligibility

To be eligible to be taxed as an S-Corporation, a corporation must meet the following criteria.

- It is a domestic corporation or a domestic entity eligible to be treated as a corporation (i.e. an LLC can elect to be treated as a corporation for tax purposes should it wish)
- It has no more than 100 shareholders (a husband and wife are treated as one shareholder for the purposes of this test, as can all members of a family)
- It's only shareholders are individuals, estates, certain exempt organisations or certain trusts i.e. no corporate shareholders;
- All of the company's shareholders are US citizens and US residents
- The company has a single class of stock
- The company is not classed as an ineligible corporation (mainly banks and insurance companies)
- The company has or will adopt a specified tax year

- Each shareholder provides their consent to the S-corporation election

Registration

To register as an S-Corporation the following is required:

- The business must be incorporated as a corporation in the state where it will conduct the majority of its business
- Articles of incorporation, by-laws and various resolutions must be drawn up
- The company must verify that the corporation meets the conditions to qualify as an S-Corporation
- An application must be made to the IRS by the 15th day of the third month following its date of incorporation

Accounting

S-Corporations need to maintain accounting records with details of income, expenses and capital investments such that the information can be provided to shareholders in respect of their relevant share of each. This is because income and expense items retain their character when they are passed-through to S-corporation shareholders. Long-term capital gains, for example, earned by the S-corporation are passed through as long-term capital gains to shareholders. Accounting for the capital accounts of each and every single shareholder is considered to be the most complicated aspect. However S-Corporations are not required to use the accrual method of accounting; they may choose the cash method or a hybrid method of accounting.

France

For businesses established as a limited company in sole proprietorship (*EURL*), an election can be made to be taxed under the personal income tax system (“*regime réel*”) or through the system of company taxation. For a private limited company in joint ownership (*SARL*) company tax applies, unless it is a special type of family business, or a small company under five years old, in which case it can also elect to be taxed under the personal income tax system. There are special regulations governing individuals such as writers, artists, sportsmen and women, or composers.

Under *regime reel* a company is liable for tax and social security contributions on net profits, being the difference between turnover and eligible business costs. In the event that the business incurs a loss in the year then losses can be carried forward up to a maximum of six years. Capital gains or losses are taxed under a separate tax regime.

This is compared to the system of company taxation, where company profits are subject to *Impôts sur les societés.* Income received by the owner is treated as a salary and is taxed through the personal income tax system, deductible for the purposes of calculating liability to company tax.

In France there is also a separate tax in relation to dividends. A general allowance of 40% is available on all dividends, irrespective of amount and to whom payable.

A shareholder is liable for income tax on any dividends received but at the bottom to middle ranges the income tax should be relatively modest. Social security contributions are payable on dividends including the social charges *CSG/CRDS*, a proportion of which is deductible against income tax. Since 1 January 2013 majority shareholder company directors who pay themselves a dividend are, in certain circumstances, subject to the full range of self-employed

social security contributions. The cost is charged to the company. This was introduced to prevent the dividend regime from being used to avoid social security contributions.

New Zealand – Look Through Company ("LTC")

Overview of rules

Under this regime a Look Through Company's (LTC) income, expenses, tax credits, rebates, gains and losses are passed on to its owners. These items will generally be allocated to owners in proportion to their ownership interest in the LTC. Any profit is taxed at the owner's marginal tax rate. The owner can use any losses against their other income, subject to the loss limitation rule. Owners' excess losses are carried forward to future income years, subject to the application of the loss limitation rule in those years. There are specific rules regarding the use of these losses if the LTC ceases to be an LTC, or if the owner sells their shares.

The loss limitation rule ensures that the losses claimed reflect the level of an owners' economic loss in the LTC. Anti-avoidance rule are in place to prevent artificial inflation of the losses around the year-end to increase the loss flow-through.

When owners sell their shares in the LTC they are treated as disposing of their share of the underlying property of the LTC. Owners may have to pay any tax associated with the deemed disposal of this property. A de minimis limit is in place in respect of chargeable gains attributable to LTC owners. Only if the amount of the disposal proceeds derived from their LTC interest exceeds the total net tax book value of their share of LTC property by more than NZ$50,000 will they be subject to tax. Even if this $50,000 threshold is exceeded, exiting owners will not have to account for tax on things such as trading stock in certain circumstances. When exiting owners account for tax on their share, incoming owners must take on a cost basis in the LTCs assets and liabilities that is equal to the deemed disposal under the disposal provisions.

The disposal thresholds do not apply if the company is liquidated, or ceases to use the LTC rules but otherwise continues in business. In these situations, the owner is deemed to have disposed of their shares at market value on the date of exit.

Look-through treatment applies for income tax purposes only. An LTC retains its corporate obligations and benefits, such as limited liability, under general company law.

An LTC is still recognised separately from its shareholders for certain other tax purposes, including GST, PAYE and certain administrative or other withholding tax purposes.

Eligibility

The conditions that must be met in order to apply the look through rules are:

- An LTC must have five or fewer owners (the ownership interests of relatives are combined)
- All owners must elect for the LTC rules to apply initially. LTC elections must be made prospectively
- Once a company becomes an LTC it will remain so unless one of the owners decides to revoke the LTC election, or the company ceases to be eligible for the treatment
- Only a natural person, trustee or another LTC may hold shares in an LTC. All the company's shares must be of the same class and provide the same rights and obligations to each shareholder

Registration

Provided the company meets the eligibility criteria it can make an application to the Inland Revenue. All owners of the company must sign the election. Within the election they must notify the year from which the treatment will apply. The earliest this can be is the following full year from the submission of the election. The process can take up to six weeks but once granted the company will have LTC status.

Consolidated tax systems

South Africa

In 2008, the National Treasury and South African Revenue Service (SARS) announced initiative to reduce the compliance burden on businesses with an annual turnover of up to R1 million (equivalent to £43,000 at the date of this report).[1]

Qualifying companies can opt to pay a single consolidated tax ("turnover tax") based on their turnover in place of VAT, provisional tax, income tax, capital gains tax (however at least 50% of the proceeds from the disposal must be included in taxable turnover), secondary tax on companies (STC) (provided dividends do not exceed R200,000) and dividends tax. A company may however choose to elect back into the VAT system. The system does not provide relief in respect of payroll taxes or associated levies.

Tax is levied on an annual basis from 1 March to 28 February each year, with tax payable in the middle of the tax year, at the end of the tax year then following submission and processing of the turnover tax return.

The highest effective rate of tax under this mechanism is 1.415% of turnover compared to a top rate of standard corporation tax of 28%.

South African rates of turnover tax

Table C.A: Turnover Tax Rates for any year of assessment ending during the period of 12 months ending on 29 February 2016

Turnover (R)	Rate of tax
0-335,000	0%
335,001-500,000	1% of turnover above 335,000
500,001-750,000	1,650 plus 2% of turnover above 500,000
750,001 and above	6,650 plus 3% of turnover above 750,000
Source:	

Eligibility

There are however certain exemptions which broadly seek to disallow the simplification for companies which are:

- Companies with shareholding interest in other companies (except for investments that are considered more of a public or social nature)
- Companies with significant investment income or income from professional services (>20%)
- Personal service providers and labour brokers

- Limit on capital disposals

Qualifying turnover is the total amount received by a business for the year of assessment from carrying on business activities. The following amounts are excluded form qualifying turnover for the purposes of determining if the R1 million limit is breached:

- Any receipts of a capital nature received from conducting business
- Specific government grants received

As they are not considered to form part of normal trading income.

Registration

Turnover tax is optional, so a business can elect in. The election must be submitted before the beginning of the tax year in question and the business must remain within the system for 3 years unless the turnover limit is breached. After this time the company can elect to deregister provided the election is submitted before the beginning of the tax year.

Latvia

Micro enterprise tax replaces state social contributions (for both employees and employers), business risk state tax, and corporate income tax or personal income tax depending upon the legal form of the taxpayer.

The micro-enterprise tax of 9 % is calculated and paid from the enterprise's turnover. If the turnover is exceeded, a tax rate of 20 % will be applied, and the enterprise will lose the status of a micro-enterprise as from 1 January of the next year.

The enterprise will still be required to register for VAT if its 12-month turnover exceeds LVL 35,000.

Eligibility

The status of a micro-enterprise payer can be acquired by a limited liability company, individual merchant, individual enterprise, or a natural person registered at the State Revenue Service as an economic operator provided they meet the following conditions:

- a turnover no more than LVL 70,000 per calendar year
- no more than 5 employees
- a salary of no more than LVL 500 per month. This includes salary; bonuses; benefits; payments into private pension funds; and life and health insurance premiums. A tax of 20 % is imposed on the amount by which a salary of LVL 500 is exceeded in a specific month

Advantages of a micro-enterprise

- The tax rate is only 9 %, and it is calculated and paid from the turnover
- An employer does not have to pay mandatory social insurance contributions
- The tax is to be reported and paid once in three months
- According to the conditions concerning micro-enterprise taxpayers no opinion by a certified auditor is needed when preparing an annual report
- No advance payments of corporate income tax are to be paid

- Members of staff can work as employees in several companies

Disadvantages of a micro-enterprise

- No tax relief is granted to employees of a micro-enterprise
- The salary (not exceeding LVL 500) must include all benefits provided by an enterprise
- The status of a micro-enterprise taxpayer can be changed to the status of a personal income taxpayer or corporate income taxpayer only after the end of the relevant taxation period (namely, a calendar year)
- If an employee works only in a micro-enterprise, the range of available state social insurance benefits is limited

Hungary

Hungary has in place a number of different consolidated tax approaches available to, amongst others, micro companies. Each has slightly different eligibility criteria and the taxes which are consolidated differ in each case.

Small business tax (KIVA)

Small business tax is payable at 16% and replaces corporate tax, social contribution tax and vocational contribution payment obligations.

The tax is calculated based on the movement between the current year and prior year amount of liquid assets recognised in the financial statements plus payments to shareholders. This amount is adjusted for certain other prescribed items. The tax base may not be lower than the amount of payments to shareholders i.e. tax is payable on at least the amount of payments to shareholders.

Single member companies meeting the following statutory requirements may choose to apply this tax type:

- average statistical headcount not exceeding 25 persons
- turnover not exceeding HUF 500 million equivalent to £43,000 at the date of this report).[1]
- balance sheet total not exceeding HUF 500 million
- tax number was not cancelled or suspended in the two years preceding the tax year
- balance sheet date of 31 December
- financial statements compiled in HUF
- business year may not differ from the calendar year

For the purposes of headcount and turnover calculation, the figures of related parties have to be considered aggregately.

Payers of this tax type shall fulfil tax advance assessment, declaration and payment obligations quarterly until the 20th of the month following the current quarter.

Simplified entrepreneurial tax (EVA)

Among other business forms, single member companies and limited liability companies have the option of the simplified entrepreneurial tax (EVA). As a general rule, EVA replaces the following taxes: value-added tax, entrepreneurs' personal income tax, tax on entrepreneurs' dividend base, corporate tax and personal income tax on dividends.

The EVA tax base is the revenue increased by VAT and modified by certain items that increase and decrease the tax base. The tax rate is 37 percent. If the total amount of the revenue and all revenue increasing items exceeds HUF 30 million, the rate of EVA will be 50 percent on the part of the tax base above this amount.

Criteria for selecting the EVA taxation scheme:

- the average of the total annual turnover reasonably expected in the tax year and in the second tax year before the relevant tax year did not exceed HUF 30 million (£70,800)
- the annual gross revenue of the company is reasonably not expected to exceed HUF 30 million in the tax year
- all members of the business association are natural persons and the taxpayer owns no shares in other legal entities
- a positive revenue was reported for the preceding two tax years

Taxpayers not subject to the Accounting Act (e.g. private entrepreneurs) are required to file their returns by 25 February of the year following the relevant year, whereas the deadline for taxpayers subject to the Accounting Act is 31 May of the year following the relevant year.

On the basis of revenues realised, taxpayers are required to make an advance tax payment by the 12th day of the month following the relevant quarter. The quarterly advance payments are required to be topped up to the expected tax amount by 20 December of the relevant year.

Small taxpayers' itemized lump sum tax (KATA)

Single-member companies may choose to apply the small taxpayers' itemized lump sum tax, provided that they are not involved in activities related to owning or leasing real estate. KATA applies a fixed rate tax based on employee numbers. By the payment of the itemized lump sum tax, the taxpayer is released from the obligation of paying corporate tax, personal income tax, social contribution tax, healthcare contribution, pension contribution, employment contribution, healthcare contribution and vocational contribution.

The company pays a lump sum tax of HUF 50,000 monthly for each full-time employee registered as a small taxpayer (or, based on his choice, HUF 75,000 due to an application for eligibility for higher social security service base). Lump sum tax of HUF 25,000 is payable by the company for each registered small taxpayer not qualifying as a full-time employee (e.g. workers employed elsewhere, old-age pensioners, employees qualifying as insured abroad). The itemized lump sum tax is payable for each person registered as a small taxpayer separately.

A taxpayer can choose to elect into KATA at any time and will be subject to tax under this regime on the first day of the month following election. At the same time, the employees themselves must be registered as small taxpayers.

The small taxpayer is required to submit a declaration on its revenue realized in the calendar year by 25 February of the year following the calendar year.

The lump sum tax is payable monthly.

While KATA doesn't replace VAT its limit is aligned such that a KATA taxpayer can also opt out of registering for VAT.

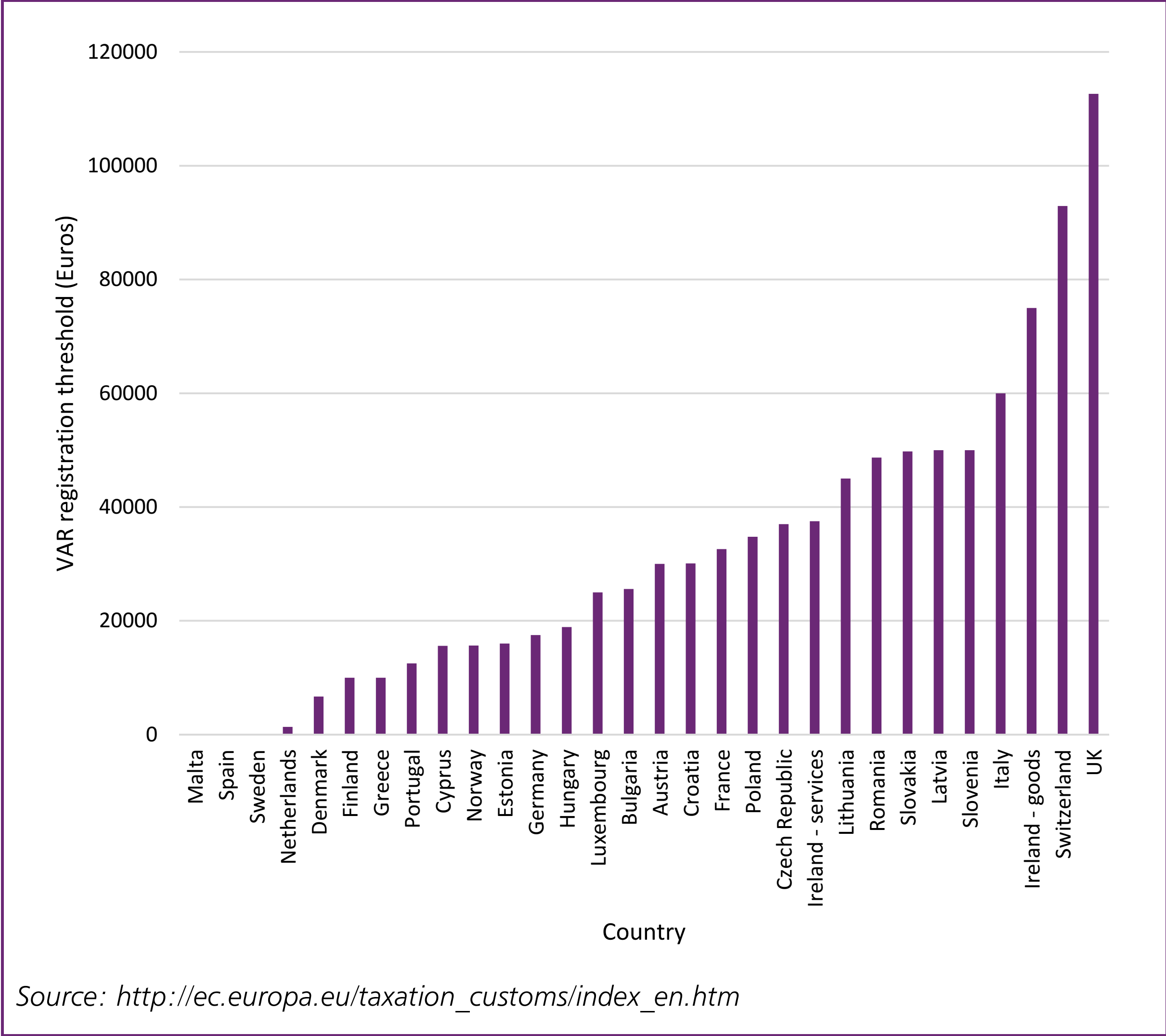
The maximum amount that a small taxpayer can earn under KATA is HUF 6million. If this limit is exceeded, tax is payable at a rate of 40% on amounts over HUF 6million (essentially a penalty). There are also limits on the amount of income that a small taxpayer can receive from a single customer (i.e. if income from that customer exceeds HUF 1million in a single calendar year it is assumed that there is an employment relationship between the parties, without evidence provided to prove otherwise.

C2. Comparison of income tax and corporation tax rates across the territories under review

Country	Income Tax	Corporation Tax
UK	Progressive rates of up to 45%	20%
France	Progressive rates up to 45% plus surtaxes for income over EUR 500,000	33.33% plus social contribution tax at 3.3% of the CIT amount
US	Progressive rates up to 39.6% plus local state taxes up to 10% which is deductible for federal income tax purposes	Progressive rates up to 35% plus state taxes ranging from 1-12%
New Zealand	Progressive rates up to 33%	28%
Hungary	15% (from 2016)	10% on the first HUF500 million then 19% above that
Estonia	20% (certain pension payments are subject to 10%)	Undistributed profits are tax exempt. Distributed profits subject to tax at 20%
Latvia	23% (except for dividends and similar income which is taxed at 10%)	15% (unless the company qualifies for micro business tax payable at 9%)
South Africa	Up to 41%	28% (though small businesses are taxed at lower rates)

Source: OTS compilation

C3. Comparison of VAT registration thresholds across EU territories



Source: http://ec.europa.eu/taxation_customs/index_en.htm

D Structures of company taxation

D1. Marginal profit extraction rates, after tax

	2015/16	2016/17
Basic rate		
Limited company salary	57.8%	57.8%
Limited company dividend	80%	74%
Self-employed profits	71%	71%
Higher rate		
Limited company salary	50.7%	50.7%
Limited company dividend	60%	54%
Self-employed profits	58%	58%
Additional rate		
Limited company salary	46.6%	46.6%
Limited company dividend	55.6%	49.5%
Self-employed profits	53%	53%

Workings[1]

Salary		
Additional profits	10,000	10,000
Employer NIC @ 13.8%	(1,212)	(1,212)
	8,788	8,788
Basic rate		
Income tax @ 20%	(1,757)	(1,757)
NIC @ 12%	(1,055)	(1,055)
Extraction	5,976	5,976

[1] Based on additional profits available £10,000, personal and dividend allowances already utilised

Higher rate		
Income tax @ 40%	(3,512)	(3,512)
NIC @ 2%	(176)	(176)
Extraction	5,066	5,066

Additional rate		
Income tax @ 45%	(3,955)	(3,955)
NIC @ 2%	(176)	(176)
Extraction	4,657	4,657

Dividends		
Additional profits	10,000	10,000
CT liability (20%)	(2,000)	(2,000)
Dividend payable	8,000	8,000

Basic rate		
Income tax (8,888 @10%)	(889)	
Less: Tax credit (8,888 @10%)	889	
Income tax (8,000 @ 7.5%)		(600)
Extraction	8,000	7,400

Higher rate		
Income tax (8,888 @32.5%)	(2,889)	
Less: Tax credit (8,888 @10%)	889	
Income tax (8,000 @ 32.5%)		(2,600)
Extraction	6,000	5,400

Additional rate		
Income tax (8,888 @37.5%)	(3,333)	
Less: Tax credit (8,888 @10%)	889	
Income tax (8,000 @ 38.1%)		(3,048)
Extraction	5,556	4,952

Self-employed profits		
Profits	10,000	10,000

Basic rate		
Income tax @ 20%	(2,000)	(2,000)
Class 4 NIC @ 9%	(900)	(900)
Net receipt	7,100	7,100
Higher rate		
Income tax @ 40%	(4,000)	(4,000)
Class 4 NIC @ 2%	(200)	(200)
Net receipt	5,800	5,800
Additional rate		
Income tax @ 45%	(4,500)	(4,500)
Class 4 NIC @ 2%	(200)	(200)
Net receipt	5,300	5,300

D2. Profit extraction rates

	Limited company	Extraction	Look-through before salary (Self-employed)	Extraction	Look-through after salary	Extraction
	10,000		10,000	10,000	10,000	
Salary = NI primary threshold	- 8,060	8,060			- 8,060	8,060
Profits after salary	1,940				1,940	1,940
Corporation tax @ 20%	-388					
Dividend = distributable profit	1,552	1,552				
Less: Personal allowance	- 2,940		- 1,000		- 2,940	
	0		0		0	
Class 2 NIC				- 146		- 146
Class 4 NIC profit @9%		-	1,940	- 175	0	0
Extraction		**9,612**		**9,679**		**9,854**
	-					
Profits	**25,000**		**25,000**	25,000	**25,000**	
Salary = NI primary threshold	- 8,060	8,060			- 8,060	8,060
Profits after salary	16,940				16,940	16,940
Corporation tax @ 20%	- 3,388					
Dividend = distributable profit	13,552	13,552				
Less: Personal allowance	- 2,940		- 11,000		- 2,940	
Taxable	10,612		14,000		14,000	
Income tax @ 20%				- 2,800		- 2,800
Income tax 5,000 @ 0%		0				
Income tax 5,612 @ 7.5%		-421				
Class 2 NIC				- 146		-146
Class 4 NIC profit @9%		-	16,940	- 1,525	8,880	-799
Extraction		**21,191**		**20,529**		**21,255**
Profits	**50,000**		**50,000**	50,000	**50,000**	
Salary = NI primary threshold	- 8,060	8,060			- 8,060	8,060
Profits after salary	41,940				41,940	41,940
Corporation tax @ 20%	- 8,388					
Dividend = distributable profit	33,552	33,552				
Less: Personal allowance	- 2,940		- 1,000		- 2,940	
Taxable	30,612		39,000		39,000	
Income tax 32,000 @ 20%				- 6,400		- 6,400
Income tax 7,000 @ 40%				- 2,800		- 2,800

Income tax 5,000 @ 0%		0				
Income tax 25,612 @ 7.5%		- 1,921				
Class 2 NIC		-		- 146		- 146
Class 4 NIC profit			41,940		33,880	
Class 4 NIC @ 9%				- 3,145	33,880@9%	- 3,049
Class 4 NIC @ 2%				- 140		0
Extraction		**39,691**		**37,369**		**37,605**
Profits	**100,000**		**100,000**	100,000	**100,000**	
Salary = NI primary threshold	- 8,060	8,060			- 8,060	8,060
Profits after salary	91,940				91,940	91,940
Corporation tax @ 20%	- 18,388					
Dividend = distributable profit	73,552	73,552				
Less: Personal allowance	- 2,940		- 11,000		- 2,940	
Taxable	70,612		89,000		89,000	
Income tax 32,000 @ 20%				- 6,400		- 6,400
Income tax 57,000 @ 40%				- 22,800		- 22,800
Income tax 5,000 @ 0%		0				
Income tax 27,000 @ 7.5%		- 2,025				
Income tax 38,612 @ 32.5%		- 12,549				
Class 2 NIC		-		- 146		-146
Class 4 NIC profit			91,940		83,880	
Class 4 NIC 34,940 @9%				- 3,145	34,940@9%	- 3,145
Class 4 NIC 57,000 @ 2%				- 1,140	48,940@2%	- 979
Extraction		**67,038**		**66,369**		**66,531**

E Survey questions

Compulsory questions marked with an asterisk.

About your company

1) How many individuals do you employ (excluding yourself)?*

2) What industry/trade are you from?*

A. Agriculture, forestry and fishing

B. Mining and quarrying

C. Manufacturing

D. Electricity, gas, steam and air conditioning supply

E. Water supply; sewerage, waste management and remediation activities

F. Construction

G. Wholesale and retail trade; repair of motor vehicles and motorcycles

H. Transportation and storage

I. Accommodation and food service activities

J. Information and communication

K. Financial and insurance activities

L. Real estate activities

M. Professional, scientific and technical activities

N. Administrative and support service activities

O. Public administration and defence; compulsory social security

P. Education

Q. Human health and social work activities

R. Arts, entertainment and recreation

S. Other service activities

T. Activities of households as employers; undifferentiated goods-and services-producing activities of households for own use

U. Activities of extraterritorial organisations and bodies

3) Are there any specific issues with the tax system for your industry?

4) Which taxes do you feel confident with dealing with yourself and which would you prefer to leave to your accountant/tax adviser (if you have one)?*

Multiple choice: (I feel confident dealing with this myself; I would prefer to leave this to my accountant)

Income tax

Corporation tax

PAYE

National Insurance

Value Added Tax

Inheritance Tax

Capital Gains Tax

Stamp Duty

Business Rates

5) Has the engagement of small companies with the tax system become easier or more difficult over the past 20 years?

Easier

Remained the same

More difficult

The life cycle of a small company

6) What influenced your decision to form a limited company?*

Multiple choice: (Strongly Disagree; Disagree; Agree; Strongly Agree)

Limited liability

Formalised structure

Enhanced credibility

To meet criteria for suppliers on certain contracts

Tax and national insurance savings

7) Have you found the process of closing a company straightforward?*

Strongly Disagree

Disagree

Agree

Strongly Agree

I do not have experience of closing a company

8) Have you found the tax system to have helped your company or companies you have represented to grow?

Strongly Disagree

Disagree

Agree

Strongly Agree

9) Do you understand the tax implications of incurring private expenditure from company funds?

Strongly Disagree

Disagree

Agree

Strongly Agree

Tax administration

10) How much do you spend on tax administration each year? I.e. the cost of completing the necessary returns and complying with tax law, not the amount of tax paid.*

11) Have you found the tax administration burdens in line with your expectations prior to starting the company?*

Much less than expected

Slightly less than expected

As expected

Slightly more than expected

Much more than expected

12) Assuming that you found the tax administration burden to be greater than expectations, would you consider disincorporation and returning to self-employment?*

Yes

No

13) Do you find that initial registration processes with Companies House and HMRC work well?*

Strongly disagree

Disagree

Agree

Strongly Agree

I do not have experience of registering a business with HMRC or Companies House

14) Do you find that the following systems work well?*

Multiple choice: (Strongly Disagree; Disagree; Agree; Strongly Agree; I do not have experience with this system)

Record keeping

Payments

Returns

HMRC intervention

15) What can be done to make online tax compliance easier?

16) Are you aware of and do you make use of any of the following allowances and reliefs?

Multiple choice: (I am aware of this; I am aware of this and I use this)

Research and Development credits

Enterprise Investment Scheme/Seed Enterprise and Investment Scheme

Entrepreneurs Relief

Annual Investment Allowance

Employment Allowance (National Insurance Contributions relief)

Patent Box

Are you aware of or making use of any allowances or reliefs not listed above?

Uncertainty

17) Please state any tax issues you have encountered that have caused uncertainty for the business.

18) Would you approach HMRC for assistance with tax uncertainties?*

Yes

No

If you have approached HMRC for assistance with tax uncertainties, was this helpful?

Yes

No

If you answered no to question 18, please elaborate below.

19) Which (if any) of the following taxes cause you particular problems with uncertainty?

Income Tax

Corporation Tax

PAYE

National Insurance

Value Added Tax

Inheritance Tax

Capital Gains Tax

Stamp Duty

Business Rates

Other approaches to tax

20) Would you welcome a different form of taxation for small companies even if this removed some of the tax advantages of limited company status?*

Strongly disagree

Disagree

Agree

Strongly Agree

Don't know

Please specify if there is a specific system you would prefer, e.g. along the lines of the self-employment tax system.

21) Would you welcome the option of preparing accounts for tax purposes on a cash accounting basis? I.e. money received less money paid out.*

Strongly disagree

Disagree

Agree

Strongly agree

Don't know

22) Are you aware of how any other countries tax small companies?*

Yes

No

If so, are there any models you would suggest we follow?

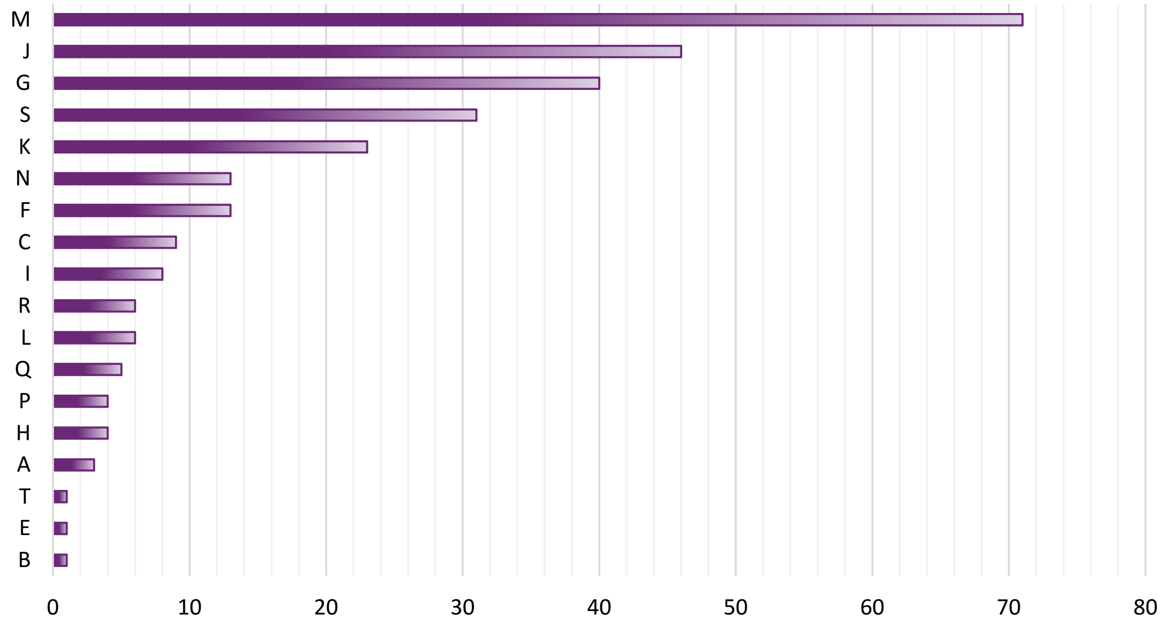
23) Finally, if you could change one thing about the way small companies are taxed, what would it be?

F Survey results

Responses to multiple choice questions

About your company

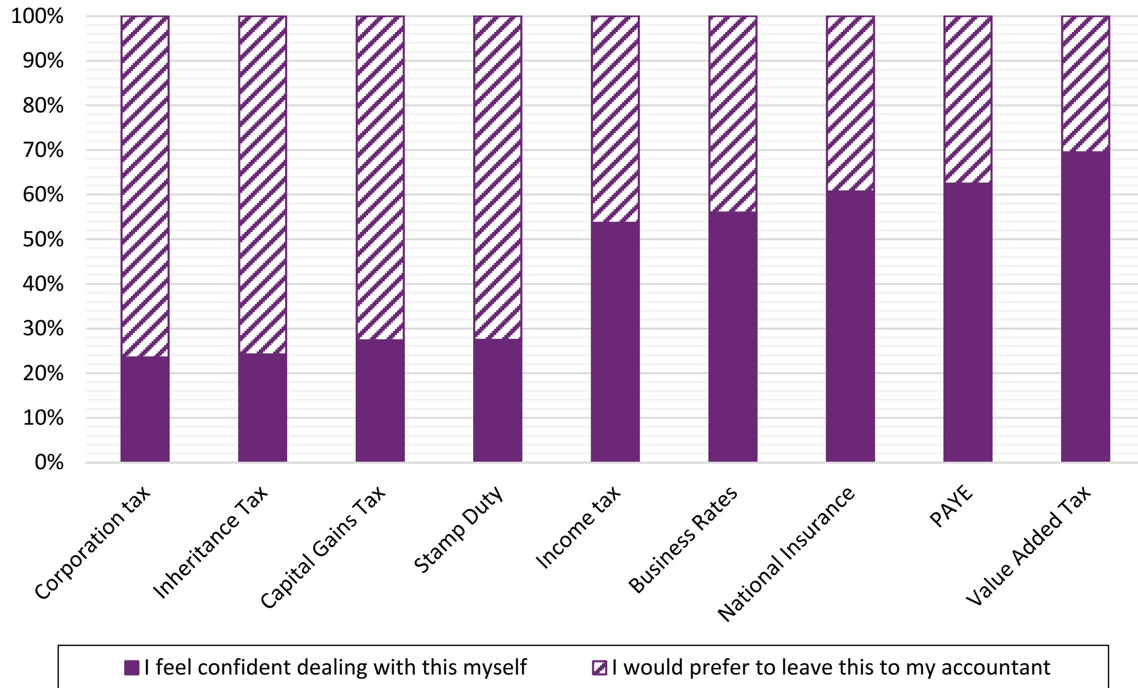
What industry/trade are you from?



Industry Sector	Count	Industry Sector	Count
A. Agriculture, forestry and fishing	3	L. Real estate activities	6
B. Mining and quarrying	1	M. Professional, scientific and technical activities	71
C. Manufacturing	9	N. Administrative and support service activities	13
D. Electricity, gas, steam and air conditioning supply	0	O. Public administration and defence; compulsory social security	0
E. Water supply; sewerage, waste management and remediation activities	1	P. Education	4
F. Construction	13	Q. Human health and social work activities	5
G. Wholesale and retail trade; repair of motor vehicles and motorcycles	40	R. Arts, entertainment and recreation	6
H. Transportation and storage	4	S. Other service activities	31
I. Accommodation and food service activities	8	T. Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use	1
J. Information and communication	46		
K. Financial and insurance activities	23	U. Activities of extraterritorial organisations and bodies	0

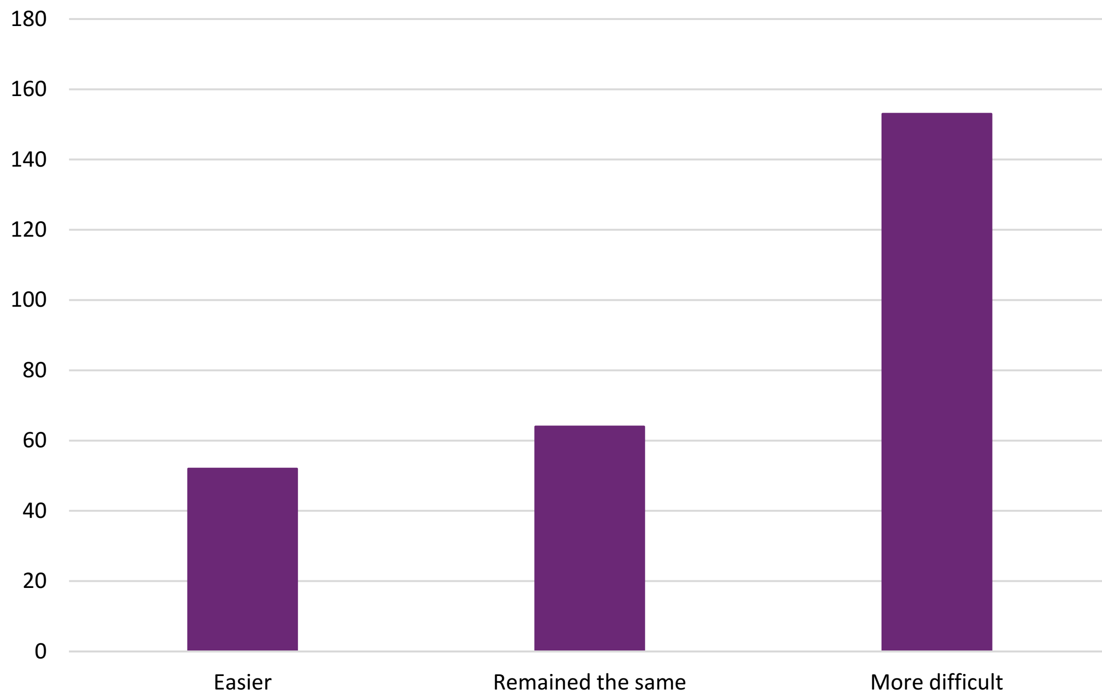
Source: OTS Small Company Taxation Review Survey

Which taxes do you feel confident with dealing with yourself and which would you prefer to leave to your accountant/tax adviser (if you have one)?

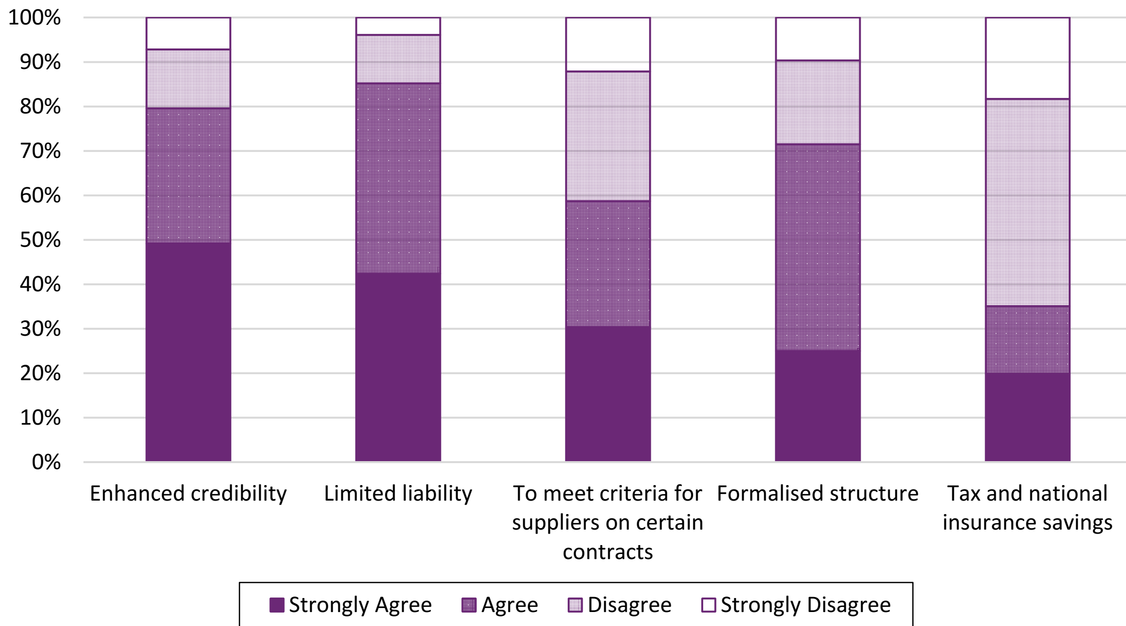


Source: OTS Small Company Taxation Review Survey

Has the engagement of small companies with the tax system become easier or more difficult over the past 20 years?

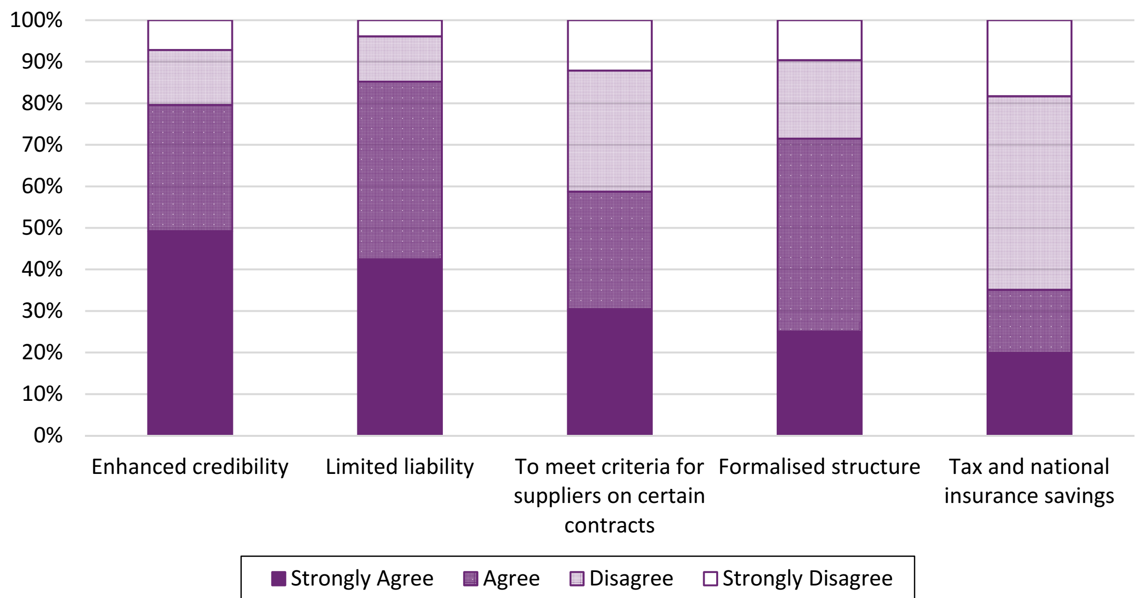


Source: OTS Small Company Taxation Review Survey



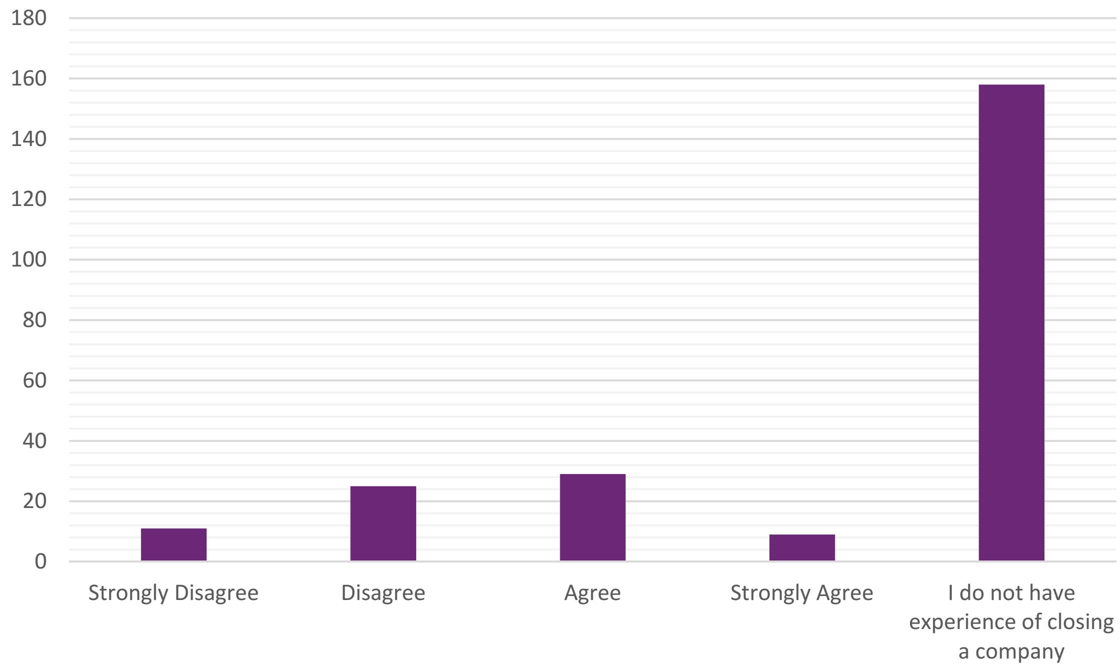
Source: OTS Small Company Taxation Review Survey

The life cycle of a small company



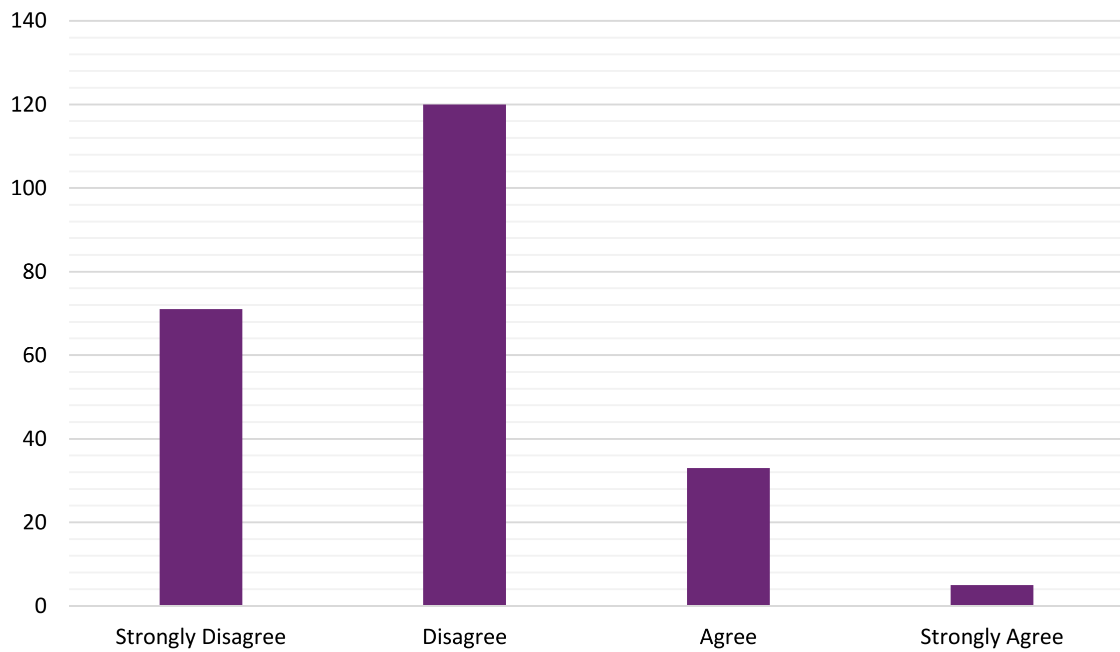
Source: OTS Small Company Taxation Review Survey

Have you found the process of closing a company straightforward?

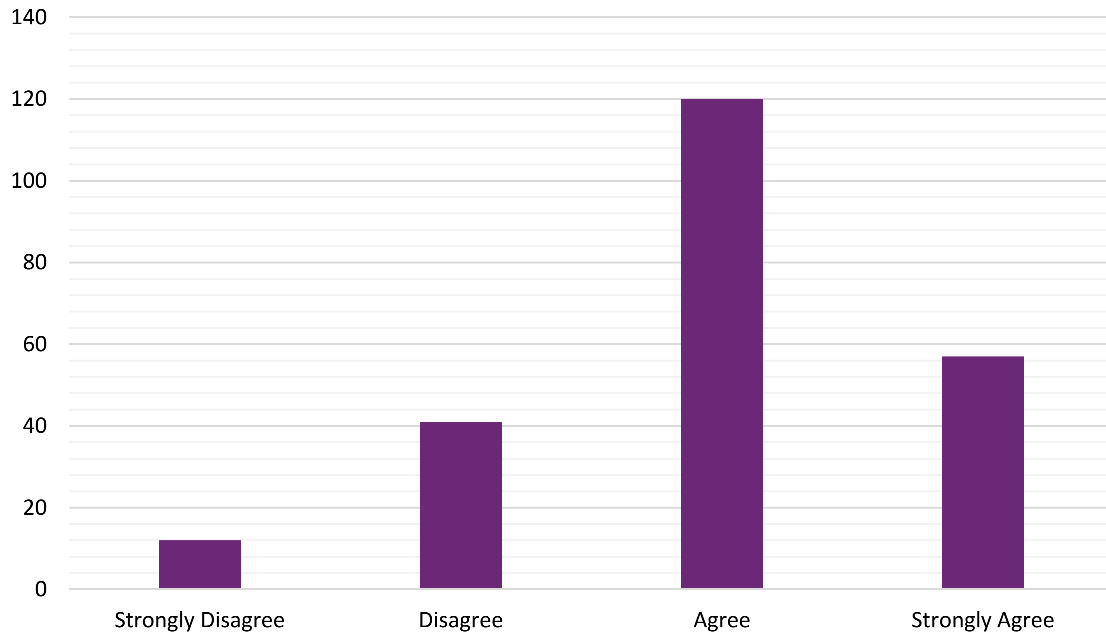


Source: OTS Small Company Taxation Review Survey

Have you found the tax system to have helped your company or companies you have represented to grow?

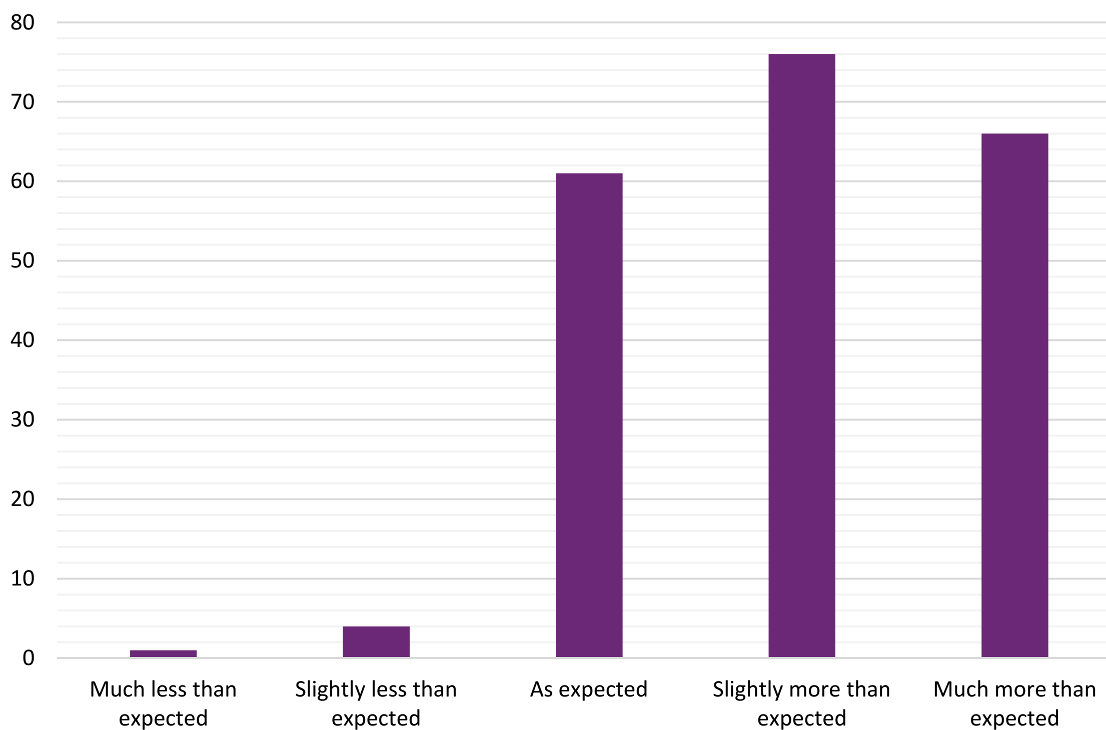


Source: OTS Small Company Taxation Review Survey



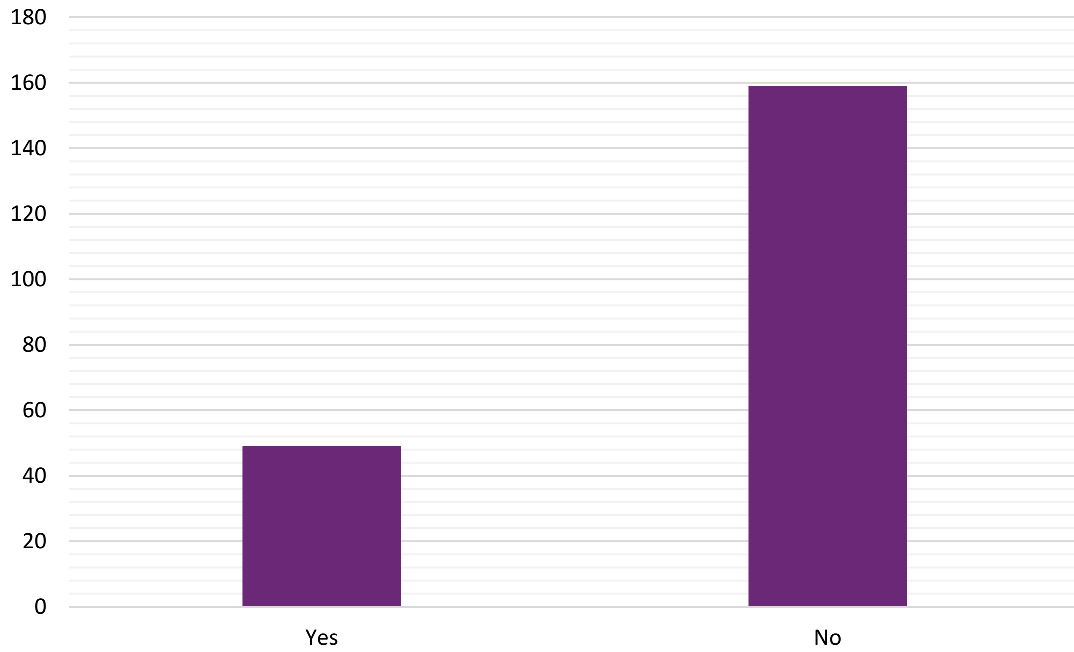
Source: OTS Small Company Taxation Review Survey

Tax administration



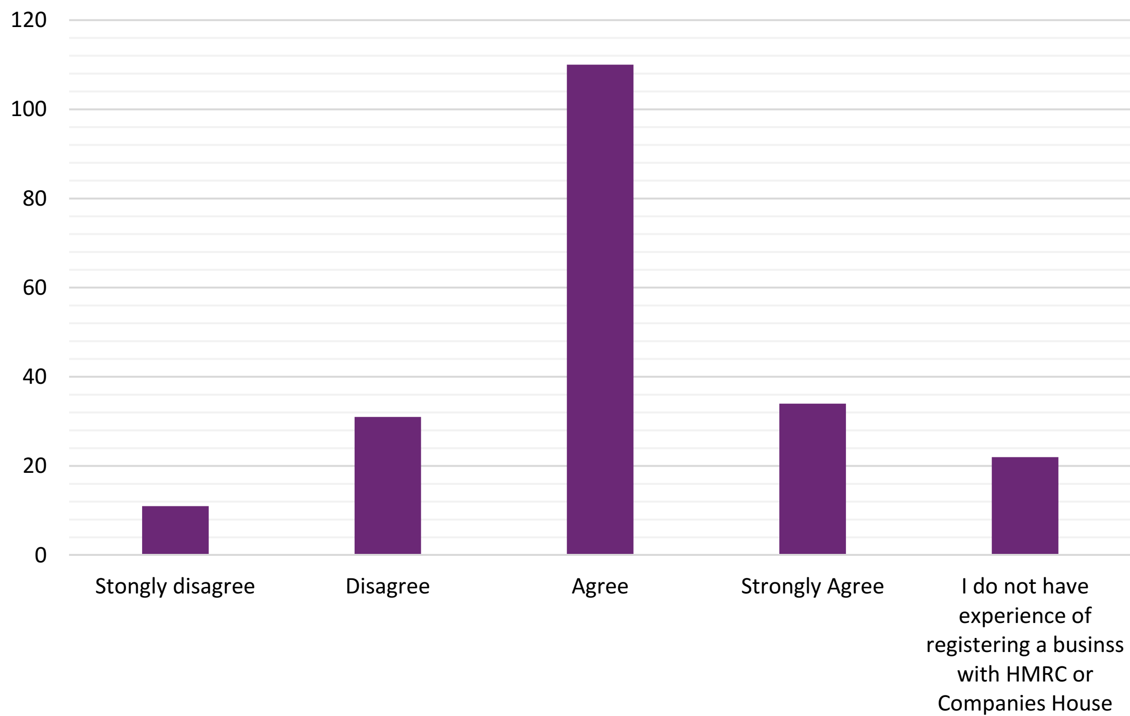
Source: OTS Small Company Taxation Review Survey

Assuming that you found the tax administration burden to be greater than expectations, would you consider disincorporation and returning to self-employment?



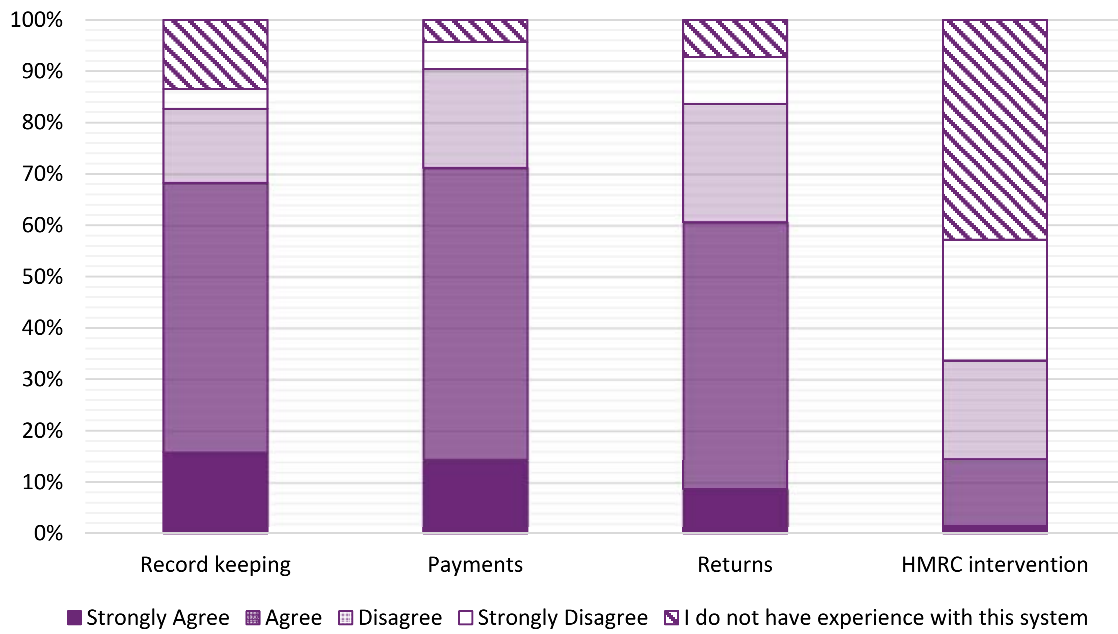
Source: OTS Small Company Taxation Review Survey

Do you find that initial registration processes with Companies House and HMRC work well?



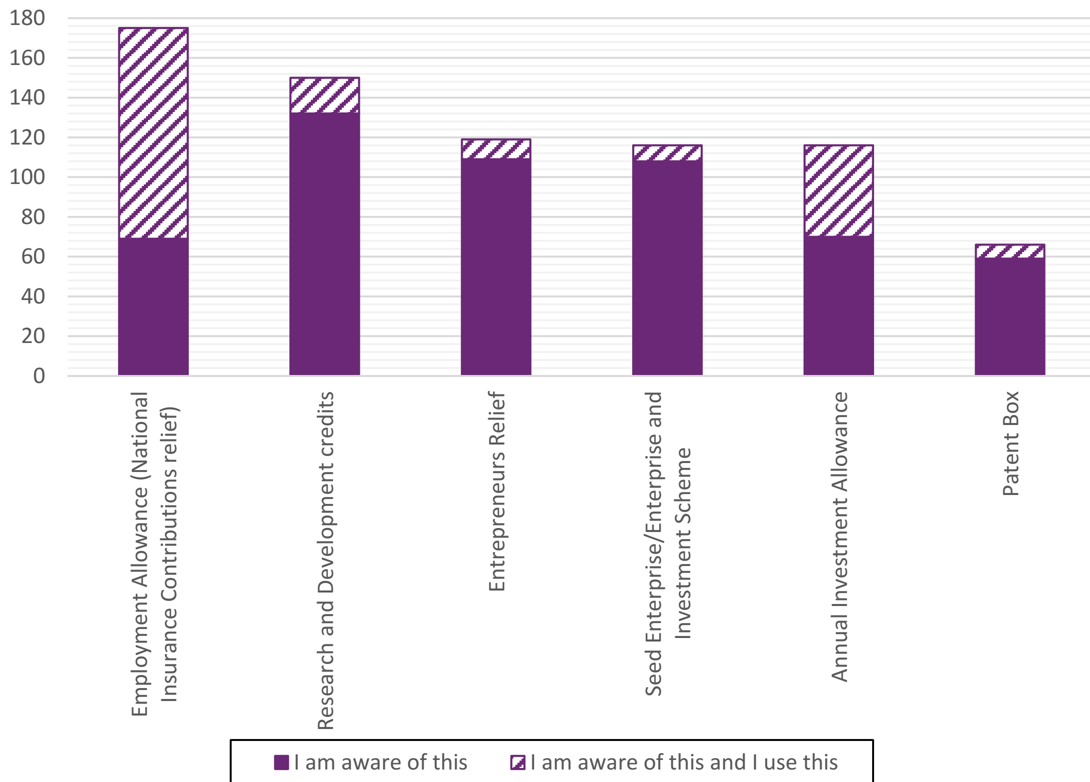
Source: OTS Small Company Taxation Review Survey

Do you find that the following systems work well?



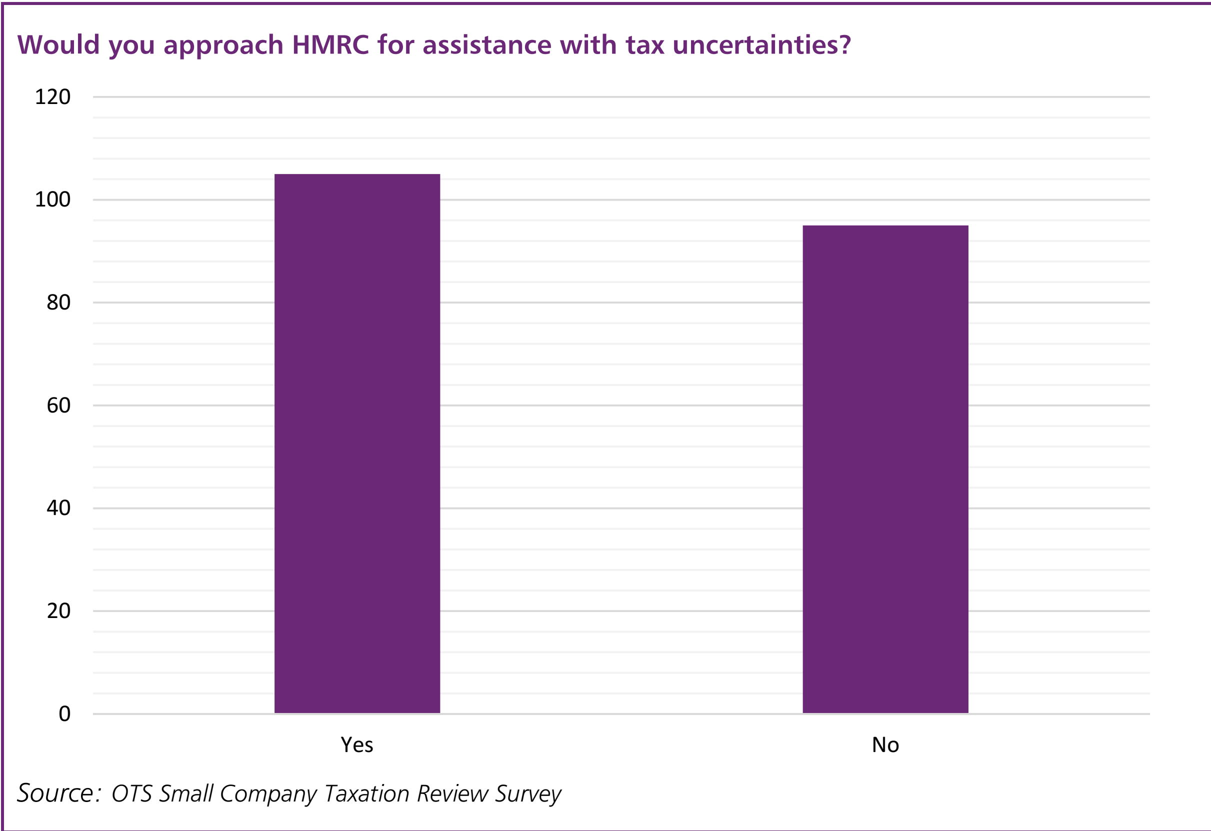
Source: OTS Small Company Taxation Review Survey

Chart Are you aware of and do you make use of any of the following allowances and reliefs?

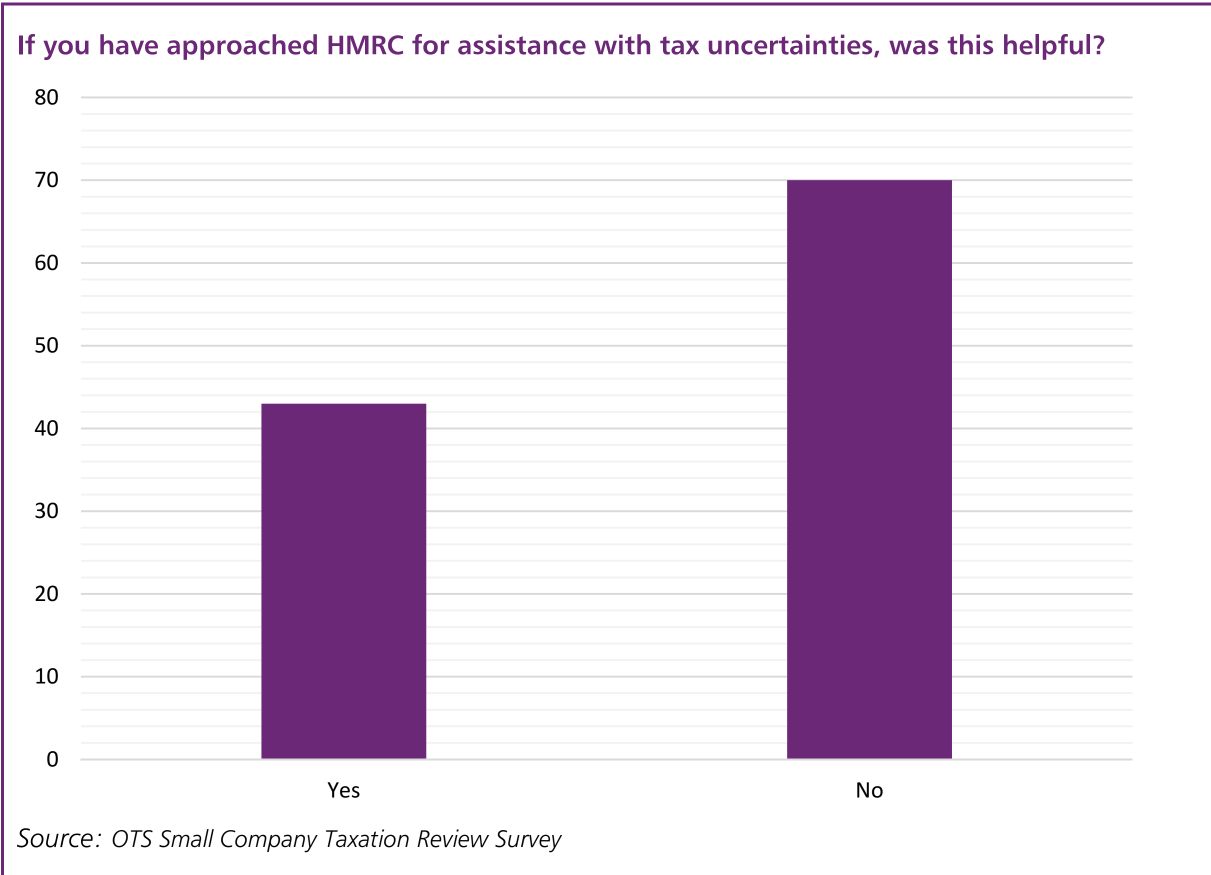


Source: OTS Small Company Taxation Review Survey

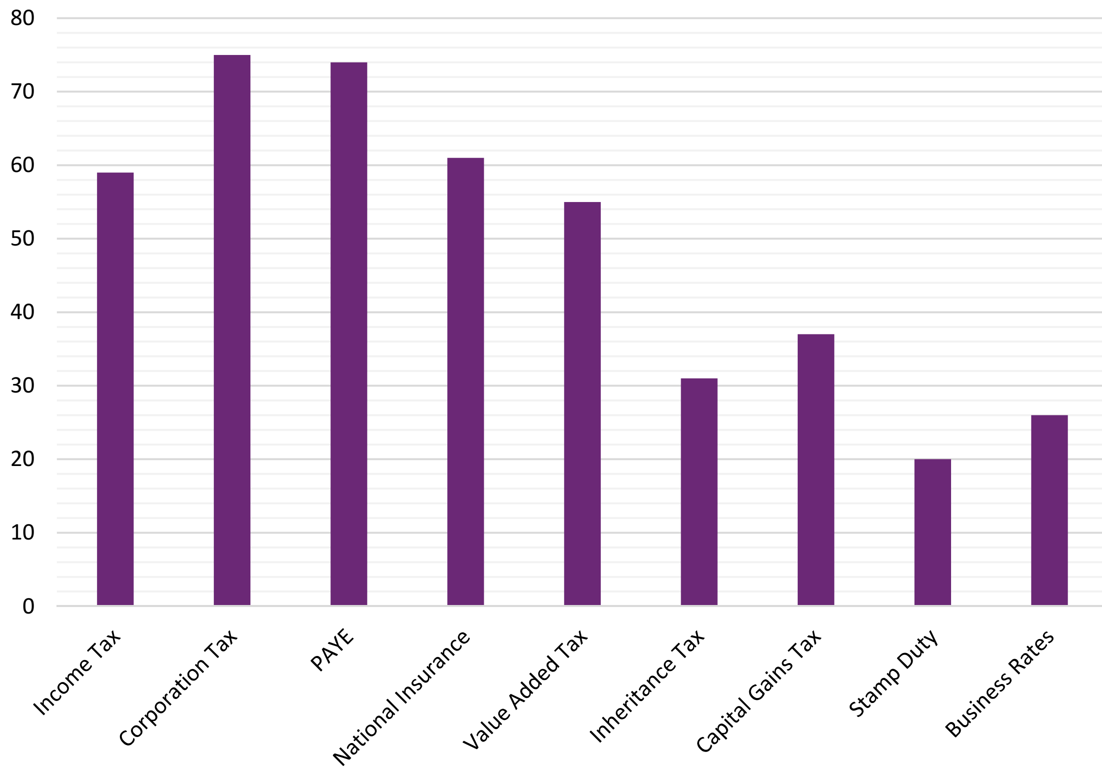
Uncertainty



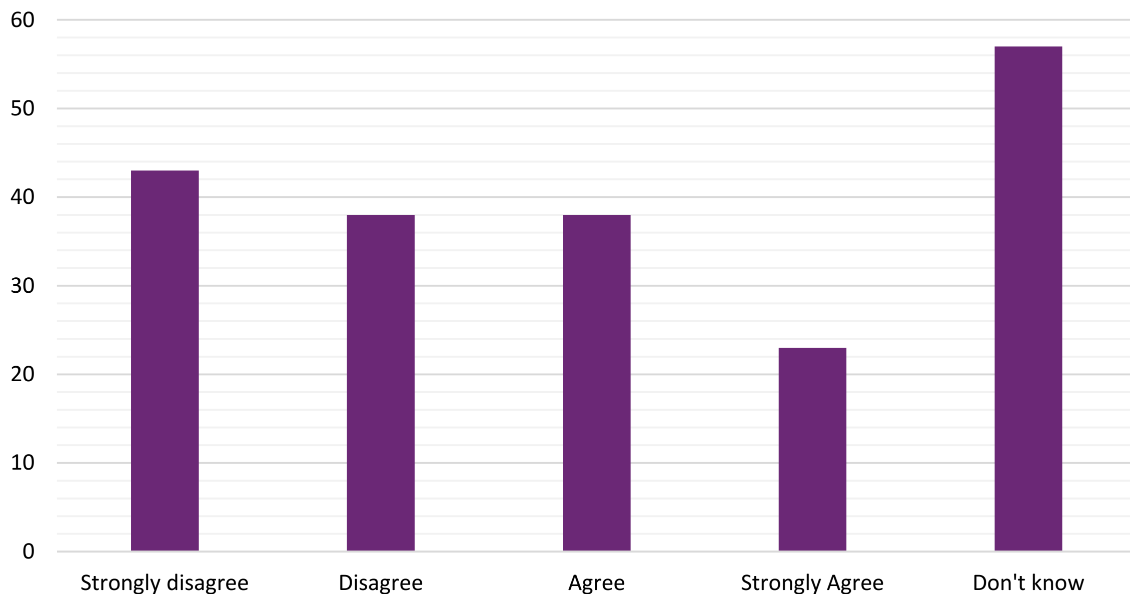
Source: OTS Small Company Taxation Review Survey



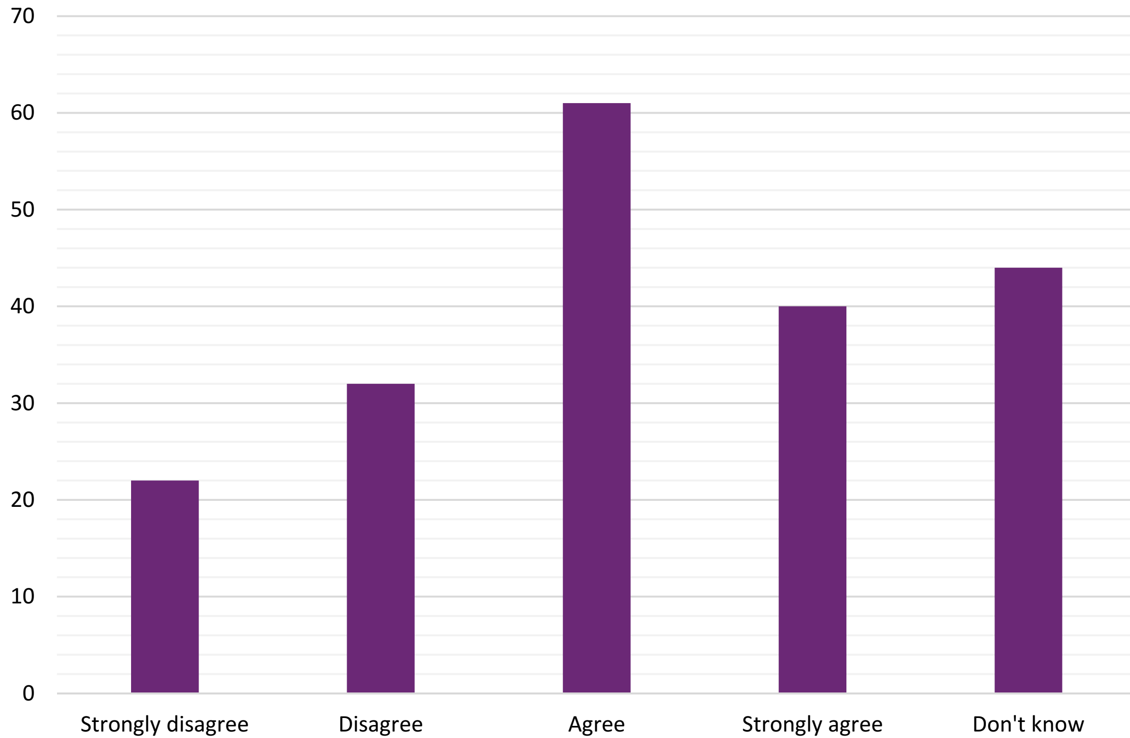
Source: OTS Small Company Taxation Review Survey



Other approaches to tax

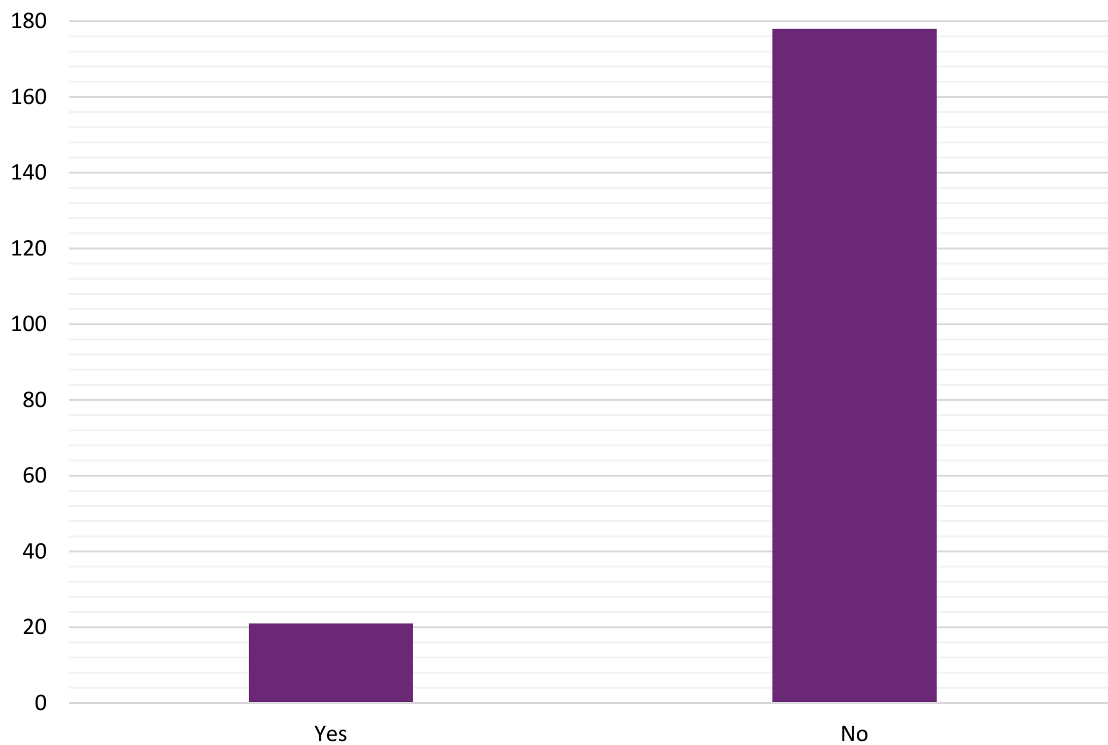


Would you welcome the option of preparing accounts for tax purposes on a cash accounting basis? I.e. money received less money paid out.



Source: OTS Small Company Taxation Review Survey

Are you aware of how any other countries tax small companies?



Source: OTS Small Company Taxation Review Survey

G Business representatives

Businesses and business groups

We conducted 52 meetings with businesses, business groups and tax advisors from around the country. We met with some on more than one occasion and many of these were round table discussions or forum events where views from several organisations were heard. Below is a list of meeting hosts (we apologise to any that we have inadvertently omitted from the list):

- The Association of Accounting Technicians
- Association of Certified Chartered Accountants
- Bishop Fleming Accountants
- British Chamber of Commerce (London)
- British Chamber of Commerce (Suffolk) and member organisations
- Broadcasting, Entertainment, Cinematograph and Theatre Union
- Representatives from the Buckingham Business Club
- The Cameron Group
- Centre for Policy Studies
- Chartered Institute of Taxation
- Chartered Institute of Taxation: Owner Managed Business
- Chartered Institute of Taxation: Low Incomes Tax Reform Group
- Citizen Advice Bureau
- Clark Crowe Whitehill
- Confederation of Business Industry
- Federation of Small Business (Northern Ireland)
- Goodman Jones Chartered Accountants
- Grant Thornton
- Greaves, West & Ayre
- Institute of Chartered Accountants of England and Wales
- Institute of Chartered Accountants of Scotland
- Institute of Directors (London)
- Institute of Directors (Suffolk)
- Institute of Directors (Northern Ireland)
- Ipswich Orwell Rotary
- Steve Collins of Leavitt Walmsley Associates Ltd

- Manchester Business Growth Hub
- National Enterprise Network
- PwC Australia
- PwC Hungary
- PwC Singapore
- Richmond Gatehouse
- Princecroft Willis
- Quoted Companies Alliance
- Scrutton Bland
- Social Market Foundation
- Taxation Advisory Services
- UK 200 Group

Government

We met regularly with several government organisations.

- Department for Business, Investment and Skills
- Department of Enterprise, Trade and Investment (Northern Ireland)
- Department for Finance and Personnel (Northern Ireland)
- Department of Work and Pensions
- HM Revenue & Customs
- HMRC Administrative Burdens Advisory Board
- HM Treasury

We also liaised with the French Embassy and the New Zealand and Australian treasury departments.

H Consultative committee

It has been the OTS's practice on our previous projects to form small, informal Consultative Committees (CCs), comprising up to 10 members. The role of the CC is to assist us with the direction of the project concerned: to suggest avenues for exploration (including people/groups to meet), to critique our plans, provide practical insights, to debate our findings and to review our ideas and recommendations. The CC has provided invaluable help to ensure we produce a report that is evidence-based, balanced and credible.

We met with the CC on three occasions and were sent a number of further comments in writing.

Consultative Committee members

- Andrew Gotch
- Angela Williams
- Asif Ahmed
- Chris Bryce
- Emily Coltman
- Erin Flood
- Professor Judith Freedman
- Rebecca Benneyworth
- Tony Thorne

Office of Tax Simplification contacts

This document can be found in full on our website at:
https://www.gov.uk/government/organisations/office-of-tax-simplification

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