The Office of Tax Simplification

Lookthrough taxation

Final Report

November 2016

Contents

This paper concludes our investigation on the potential for lookthrough to offer tangible tax simplification benefits to small companies. The paper takes forward the conclusions in our March report[1] by considering the issues raised in our discussion paper[2] published in July. It focusses on further findings during this final stage; it does not repeat those previous papers though the summary of the subject in our main March report, which gave rise to this work, is included at Annex C for ease of reference.

[1] 'Small Company Taxation': published on 7 March: https://www.gov.uk/government/publications/small-company-taxation-review

[2] 'Lookthrough discussion document' published on 18 July: https://www.gov.uk/government/consultations/lookthrough-discussion-document

Introduction and summary

The basic premise of lookthrough taxation for a small company is that direct profits taxes are not levied on the company; rather one looks through the company and levies taxes directly on the shareholders on their allocated share of the profits. This obviates the need for company taxation; potentially lookthrough puts small companies and sole traders on the same footing with similar tax on similar profits.

The OTS's objective is to provide genuine simplification to the tax system – both in terms of reducing its technical complexity as well as providing administrative simplification for users. On the surface, lookthrough offers simplification benefits so we have considered it through this perspective, judging the potential simplification benefits to its users against any complexity it will bring, the inevitable complexity of change and of course wider non-tax implications.

As always we have sought views from stakeholders and we have been pleased to receive a good range of comments following our July discussion paper[3]. We have been to meetings and roundtables across the country[4]. Our conclusions are based on stakeholders' views and further desk-based research.

In our July paper we identified a range of issues to consider and relevant criteria under which to evaluate lookthrough. These were endorsed by stakeholders. The crux was our summary question: ***Overall, would lookthrough deliver simplification?***

Whilst there are inevitably some pros and cons in arriving at the answer to this question, overall, the answer from a tax simplification perspective, is **'no'**.

In practice, once the accounts (which would still be required for lookthrough companies) have been developed, the CT compliance burden is modest and tends to be dealt with in parallel. The simplification gained by eliminating the need for corporate tax compliance is outweighed by the technical issues that such a process raises, especially as there would still be a need for an 'adjustment of profits' exercise. In addition, whether or not lookthrough would deliver tax simplification, the OTS will always consider wider issues and here there is a key point: lookthrough potentially damages the funds retained for investment by taxing retained profits at full income tax/NIC rates. Many also suggested it would discourage entrepreneurs.

We tried to answer that last point during the small company taxation review by focussing lookthrough on a core of companies that did not retain funds. Defining such companies has proved to be impractical and in practice would only really be workable by offering lookthrough as an option, and relying on self-selection. That route raises further issues: the inherent complexity of offering the choice; the risk that it becomes a 'lowest tax' choice; and the complexity added by any rules introduced to prevent 'gaming'.

Cash accounting was a regular issue in discussion: there was a lot of support for getting to a position where the smallest companies could use cash accounting (though with the obvious caveats about most companies needing full accounts), something that is not possible under current rules. Some suggested that if lookthrough were to apply, cash accounting should be available to impacted companies. But an override here is simply that any move to try to simplify tax through lookthrough would not remove any of the wider compliance obligations of running a company such as publishing accounts and making annual returns.

Thus from a tax simplification point of view, **we would not recommend lookthrough as a method of simplifying tax for small companies**.

[3] Annex A is a summary of the views expressed in response to the questions posed in the July discussion paper.
[4] See Annex B for a listing of contributors and meetings

1 What is lookthrough?

1.1 As noted above the basic premise of lookthrough taxation for a small company is that direct profits taxes are not levied on the company; rather one looks through the company and levies taxes directly on the shareholders on their allocated share of the profits[5]. Shareholders would be subject to income tax and class 4 NICs[6]; however, all other requirements of the company will remain. This includes VAT compliance (if the company is registered) and accounting requirements.[7]

1.2 Apart from the possible tax simplification aspect, one of the main arguments for lookthrough is that it could put individuals who channel their activities through a company and those who act as sole traders on the same taxation footing. It is well known that sole traders can save tax by incorporating their activities in some circumstances[8] though as previous OTS reports have shown, there are many other reasons why taxpayers incorporate and use a limited company vehicle.[9] The differing tax results stem from the differences in taxation of income and capital, together with the differing NIC imposts (in particular the employer's NICs if the comparison is extended to employees).

1.3 Although lookthrough would broadly balance these different taxation results, it does not provide an optimal solution. It is more in the nature of a sticking plaster, one that is difficult to apply and also may not cover the 'wound' properly (hence our suggestion in para 1.5 below). It would leave the taxpayer with all other corporate obligations in place which may cause confusion and scope for error and also put companies to which lookthrough applied on a different footing, probably with higher taxes, than other companies. However, it seems to us that there is no simple way of addressing TMI or tax inequality and moves to tackle these issues will result in some increase on tax on retained company profits that could be used for future investment.

1.4 We are conscious that in discussing the higher taxation of retained profits under lookthrough we are moving away from pure tax simplification and into more of a policy area. But it would be remiss of us not to address the subject as it was so clearly in the minds of so

[5] For ease of illustration at this stage, we consider mainly 'trading' income but potentially all income and gains of the company would be allocated. We consider the implications of this further later in this report.
[6] Class 4 NICs is on the assumption that the income allocated would count as self-employed trading income. However, that NIC treatment cannot be guaranteed: lookthrough is not a guarantee of self-employed 'treatment'. The IR35 rules would still be in point for some companies.
[7] Lookthrough is a concept that features in a number of countries' tax systems (e.g. USA and New Zealand) in some form, often producing a lower tax bill for the shareholders than would be the case if company tax remained in place.
[8] Often referred to as 'Tax Motivated Incorporation' or TMI.
[9] See in particular the Ipsos Mori survey for HMRC

many of our stakeholders. It has to be relevant to any consideration of changes in this area of the tax system.

1.5 There is an argument, which has been raised by respondents both for and against lookthrough, for an overall review of the way of taxing rewards for working (namely, sole trader vs employee vs working through a company). This is especially as the trend towards lower corporation tax rates does provide further incentives to incorporate and perhaps could be perceived as a signal that it is the route that should be taken. Any such review would be a long-term study and would include considering whether the tax system should indeed offer some form of discount/reward for risk-taking as, whether or not deliberately, it appears to at present[10]. It would also have to consider interactions with benefits (both contributory and non-contributory): as the OTS income tax/NICs alignment project shows, aligning NIC payments by employees and the self-employed attracts a good deal of support – provided they generate similar entitlements.

[10] In saying this, we are well aware that economists would tend to be against this in principle (it is conceivable that this is compensated for by the market) but it is important to take account of the fact that the benefits available to the employee (e.g. through employment rights and contributory benefits) are greater than those available to the self-employed (although this gap has narrowed with the improvements to state pensions for the self-employed).

2 Key Issues

What we have done

2.1 Following publication of our Small Company Taxation report, Ministers accepted our recommendation that we should explore further the possibilities afforded by a lookthrough taxation system. We therefore:

- published a discussion paper in July
- carried out our own researches
- met with a range of stakeholders (often in meetings which also considered SEPA) both before and after publishing the July document
- received a number of written submissions
- continued to liaise with colleagues in HMRC, HMT and BIS (now BEIS)

A list of contributors is in Annex B.

Key issues

2.2 Our July paper codified what we saw as five key issues in considering lookthrough:

- Who would lookthrough apply to (or be available for); is it possible to define easily the affected taxpayers?
- How would it apply: how would profits be allocated to proprietors?
- What tax consequences ensue: how would the tax be collected?
- Would this be an optional, default or compulsory system?
- Overall, would this deliver simplification?

2.3 Stakeholders' responses confirmed that these are the correct criteria against which to evaluate lookthrough. The rest of this paper therefore summarises our findings against these issues and brings out some of the main implications, though first we address a preliminary issue.

How much complexity is there?

2.4 The premise of lookthrough as far as tax simplification is concerned is that it removes a layer of complexity: the company no longer has to do any corporate tax compliance. As proprietors are going to be in the income tax net already, they would not suddenly be drawn into a different system[11].

2.5 We therefore tested in our meetings just how significant the CT compliance burden was.[12] The general answer seemed to be 'not much', given that an adjustment of profits exercise would still have to be done at shareholder level and so it would not be eliminated[13]. Thus as long as a company needed to draw up full accounts, eliminating the requirement to do a CT computation was a modest saving.[14]

2.6 Clearly there would be savings in only submitting and settling one tax return (for income tax) rather than two (for income tax and corporation tax), though some noted that lookthrough may well result in more shareholders having to submit ITSA returns. One firm that dealt with large numbers of small companies (mostly PSCs) commented that they offered a 'care package' service, which covered all matters: if CT was eliminated there would be little or no difference to the overall cost of the service package.

2.7 Thus if lookthrough is to be introduced, any extra complexities introduced through the allocation process will have to be small if the overall admin burden is not to increase.

Who would lookthrough apply to (or be available for); is it possible to define easily the affected taxpayers?

2.8 In our March report we tentatively suggested that lookthrough might be an effective simplification for companies that:

- generally do not intend to increase in size
- are effectively one-person businesses
- distribute all (or almost all) their profits
- have few assets or need for investment funds

[11] Though they would not necessarily be completing a self-assessment return.
[12] It is worth noting that according to one very experienced practitioner and professional body representative, overdrawn loan accounts was the single biggest issue connected with corporate tax compliance. We return to this issue later.
[13] Many also make the point that for the smallest companies the adjustments needed for the CT/ITSA computations are usually similar each year and relatively few. However, it is clear that there is a cost and a burden: HMRC research (see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/443746/HMRC_Report_375_Tax_Administration.pdf) highlights that agents charge small businesses £341 on average to complete their CT return (this includes both completing the computation and filing the return). The average time taken by small businesses to complete their return is 12 hours and 58 minutes. Micro businesses self-report that completing all aspects of the CT return costs them £1,853 on average, though this figure is likely to be an overestimation. It is for these reasons the OTS is carrying out a review to look at streamlining the corporation tax computation.
[14] These comments do to a degree conflict with the many calls we have had to simplify corporation tax, which have led to our current project on streamlining the corporation tax computation. However, the views can be reconciled: those who argued that the CT computation was relatively easy were comparing it with an adjustment of profit exercise for a sole trader. There is clearly scope for both to be streamlined, preferably in parallel.

2.9 This has generally been supported but many concerns have been expressed as to how easy it is to effectively define such businesses (we discuss below whether making the system optional would solve the issue).

Impact on growth

2.10 Of the four characteristics above, identifying companies that did not intend to increase in size proved to generate the most discussion. The current taxation system allows growing companies to retain funds for investment with only a low rate of tax paid. Of course, the downside of this is that it also provides a tax motivation for incorporation where owners have no intention of investing the profits to grow their business. A lookthrough system would tax all profits, often before they could be invested. The annual investment allowance is only a partial solution to this as:

- saving up for a large investment often takes place over more than one year (for example purchasing new farming equipment)
- investment can be as much in working capital as plant and machinery
- for many small companies, cash *flow* is just as important as total cash

2.11 We were regularly told, in almost every meeting and often in very strong terms, that lookthrough would damage investment and enterprise, though our response continues to be that we fully understood the concerns and were attempting to define the businesses that would not be affected. That tended to flow into further points about retaining funds for flexibility.

Retaining funds for flexibility

2.12 This was an important consideration for many of the smallest companies (including many PSCs). Proprietors often want to use the company to 'smooth' their income: to spread a good year into the next year that might not be so good; to cover an extended holiday; simply to have money in the corporate shell against a 'rainy day' (which might include illness). Should such income be taxed in full, before it is drawn? Users make the point that it will be drawn out in due course and it is more appropriate to tax it then (and at rates at that point) though this is not as strong a concern as the investment point.

Identifying relevant small companies

2.13 We have identified three broad routes that could be used to identify a target group of companies:

- turnover: under £x, the obvious level being the VAT threshold
- shareholders: those with a single shareholder (or single material shareholder)
- employees: those with no employees (other than the main shareholder)

2.14 A turnover level test is relatively simple (a variant could be businesses that are not registered for VAT perhaps). Testing via the number of shareholders would be open to some manipulation of shareholdings in family situations. An employee route again opens up manipulation among family members (though potentially does ensure more salaries are paid out – if that is indeed the objective seen by some).

2.15 The problem with these options is that they are rather blunt instruments and do not make allowances for the profit retention points just made. All would need extensive and careful definitions in the legislation, given that companies could try to manipulate the rules. That adds complexity. We found no consensus on the best route and many said that it would be better to sidestep such a definition by making lookthrough optional.

How would it apply: how would profits be allocated to proprietors?

2.16 The working assumption that we have tested is that all profits – including trading income, investment income and capital gains – would be allocated according to shareholdings. There would be nothing left in the company to tax. Some prior items that we identified in our discussion paper, such as preference share dividends, would stand, but all remaining profits would be allocated. This implies some form of additional return being required, presumably a schedule along the lines of a partnership allocation which would be centrally generated by the company or its advisers and given to each shareholder to help with their tax return.[15]

2.17 We did get a suggestion that profit distribution independent of shareholding be allowed. Owners could submit a distribution return where they state how profits are distributed among shareholders. Although we understand the rationale for this, we cannot support the idea: it adds an extra layer of administration and has obvious risks of manipulation.

Salaries

2.18 Many small companies pay salaries to some or all proprietors. A key question is whether these would be added back so that 'gross' profits are allocated or whether the salaries stand and 'net' profits used.

2.19 We were regularly told that many family companies use salaries as a means of allocating income between family members: essentially that the working members get salaries, with dividends to shareholders – who often include non-working (or lesser working) family members – being little used. Similar arguments would apply to many other commercial businesses. All this supports the argument for allowing salaries to be left undisturbed. If salaries are not left to stand, it would mean a system of PAYE/NICs credits against eventual lookthrough liabilities would have to be set up.

2.20 Alternatively, perhaps a lookthrough company could ignore salaries (these could be paid gross?) and allocate full profits. But that raises obvious concerns about lack of money to meet eventual tax bills.

[15] No doubt in many cases all of this would be done by one set of advisers – indeed one software producer suggested it would be easy to develop a lookthrough allocation module to add on to existing tax software. We have not sought to explore this at all.

What tax consequences ensue: how would the tax be collected?

2.21 As already noted, allocated trading profits would need to be adjusted for tax purposes. A decision would need to be taken whether CT or IT rules would apply: although very similar, they are not the same (for example deductions for R&D)[16].

2.22 However, as companies will have other forms of income and gains, those will all have to be allocated. We have assumed, as a principle, that the income in the company would retain its identity when allocated (that is investment income in the company would not be turned into trading income when allocated). Annex B contains some analysis of the issues identified by stakeholders and ourselves; to give a summary:

- **Capital allowances:** how would AIA work if the owner(s) had other businesses which also invested?
- **Other income:** the interaction with the new dividend allowance and personal savings allowance would potentially add complexity.
- **Capital gains:** gains allocated to the shareholders would have to be eligible for rollover relief and substantial shareholdings exemption, if they would have been so eligible in the company, implying possibly complex additional rules. The fact that the shareholders may be able to use their annual exempt amount against allocated gains was noted as helpful but would the gains be subject to indexation? And of course the differing rates of CGT would be in point.
- **Losses:** we had noted losses as an area of potential complexity. How would offsets be allowed – would there be further anti-avoidance provisions?
- **Benefits to proprietors:** what if the benefits were being payrolled under the new rules? Would that have to be unwound? How would private use be dealt with? What expenses rules would be used?
- **Double taxation:** would there be a general rule to ensure that lookthrough did not tax the same profits twice? How would that work across years?
- **Pension contributions, charitable donations, tax credits and student loan repayments** would all be affected.
- **Non-resident shareholders:** how are they dealt with?
- **Double tax relief:** would need rules in both directions.
- **Construction Industry Scheme:** a company may be registered for CIS; would that registration carry over to the individual(s) and if so would the applicability change at all?

2.23 All of the above are potentially soluble but all would seem to need additional rules, some of which would be complex and thus add to the general compliance burden.

Paying the tax

2.24 If lookthrough allocates the profits to shareholders, they will have to return those profits and pay the tax. That would raise issues in practice in some cases about shareholders' rights

[16] The OTS has already pointed out the way that allowances can differ between differing business formats. Often they provide another motivation for incorporation. We have recommended that such differences be eliminated; so far little has been done on our recommendation on grounds such as cost and that unincorporated businesses undertake little R&D.

against the company to reimbursement for tax paid. Clearly that would not be an issue for a standard personal service company situation but might be a problem for minority shareholders who may not be able to ensure the company actually pays out appropriate dividends. Would there have to be some form of override legislation compelling a lookthrough company to make distributions?

2.25 As personal tax liabilities, the ITSA payments dates rather than the CT payment dates would apply, with payments on account relevant.

Directors' loan accounts

2.26 Lookthrough does offer some simplification here. Many company directors struggle with separating company and personal income and with keeping appropriate records, especially when they're the sole shareholder and are operating as a personal service company. Lookthrough potentially eliminates the tax issues that arise with overdrawn directors' loan accounts. However, company law issues around such accounts would remain.

Value added tax

2.27 If VAT is to continue to be accounted for by the company (which most people saw as obvious) it does mean the company cannot fully disengage from tax compliance.

2.28 On a computational point, if there was irrecoverable VAT in the company, the current tax system assumes it to be deductible in the profits computation for the company and hence in the allocation under lookthrough.

2.29 VAT implications could be minimised by making the lookthrough boundary equal to or less than the VAT registration threshold. However, it is clear from our evidence gathering that many small companies with turnover below the threshold register for VAT to take advantage of the VAT flat rate scheme, or simply to add to their image as businesses that are well-established and fully compliant.

Cash accounting

2.30 Although not directly a tax consequence, it is appropriate to consider cash accounting here. It will be appreciated that an unincorporated trader can use cash accounting; a company, however small, cannot. If lookthrough operates on the company, that would not alter the requirement for the company to prepare full GAAP accounts. That requirement is currently governed by EU rules; [17] it is in principle possible that the rules could be changed in future years with Brexit, but there are sensible policy reasons for requiring companies that exist as legal entities in their own right to have some reporting requirements.

2.31 There was support for offering companies affected by lookthrough the use of cash accounting. Many of the smallest companies do not have large amounts of non-cash assets,

[17] The EU Accounting Directive currently allows for micro companies [ref needed] to use some elements of cash accounting, known as 'cash plus' accounting. However, use of cash plus accounting is limited to the very smallest companies, essentially those resembling personal service companies. Any company with stock, for example, would have to report this in accordance with GAAP.

creditors or debtors. They do not have large variations between accounting periods and are often operated by shareholder/directors that already have a sufficient working knowledge of the company to make informed business decisions. Many of these owners are not trained in accounting principles and do not understand how to interpret GAAP accruals accounts.

2.32 However, we fully acknowledge the value of full GAAP accounts to businesses that have (for example) significant trading stocks and/or capital assets, a point emphasised by many advisers. We would not in any way seek to say that small companies should not do GAAP accounts: just that, as with unincorporated businesses, there are many who do not need them and derive no benefit from them.

Would this be an optional, default or compulsory system?

2.33 Applying lookthrough to all small companies would bring complexities in operation out of proportion to the benefits. We rarely found support for any form of compulsory (or automatic) system among stakeholders. Almost all who supported lookthrough – and they were in a minority – did so on the basis that it would be optional.

2.34 Making the system optional has the great benefit of getting over one of our key hurdles: applying lookthrough only to those companies that would find it a simplification. As discussed above, trying to define companies to which lookthrough should apply is difficult to do without importing much complexity. An optional system is, clearly, self-selecting: any company that needed to retain funds for investment, for example, would opt out of (or, if it is a default system, not opt into) lookthrough.

2.35 However, an optional system brings two obvious problems:

- The administrative burden (and potential adviser costs) for the company in assessing whether it should opt for (or out of) lookthrough;
- The risk to the Exchequer that the only companies that opt for lookthrough would be those that see it as a route for saving tax.

2.36 To a degree these issues could be managed by making the option for lookthrough one that could only be applied (say) every five years. But that immediately brings problems over flexibility and risks businesses being shut down and reformed to manage the situation. One can already see, in just briefly discussing some of the risks, the sort of further complexity that would be introduced by any rules to prevent 'gaming'.

3 Conclusion

Overall, would this deliver simplification?

3.1 The simplification benefit of removing the corporation tax obligation alone is limited. This simplification benefit is further reduced given that an adjustment of profits exercise would still have to be carried out at shareholder level. Advisers, used to producing tax returns for companies, tend to calculate corporation tax as part of the accounts creation process at little or no extra cost. The compliance process for corporation tax would be eliminated by lookthrough but replaced by a similar process for income tax, often with extra issues arising. Those (few) companies capable of creating their own GAAP accounts would probably find the corporation tax element as a relatively straight forward calculation.

3.2 Although lookthrough tries to even up the tax bills for the unincorporated trader and the equivalent business conducted through a company, it does so by increasing the tax immediately due on retained profits. That risks damaging investment. Although that is straying into wider policy matters beyond pure tax simplification, it has to be part of the debate and we have tried to address it by targeting a system on companies that do not retain profits. That is difficult and unreliable. In many ways, the only reliable way around this would be to make lookthrough optional – which brings its own complexities.

3.3 In any event, once one goes beyond simple trading income to other forms of income and gains, allocating them raises a lot of technical issues and would, we think, require complex legislation and procedures.

3.4 **Our conclusion is that lookthrough does not offer sufficient simplification to justify its introduction. On balance we feel that it would actually be more complicated than the current corporation tax system, given the additional rules that would be needed.**

3.5 Whilst we do not recommend lookthrough from a tax simplification perspective, we have heard arguments in favour of lookthrough as part of a more radical reform of the tax system, including potential greater equality in the taxes paid by self-employed traders, company owners and indeed employees. Likewise we have heard equally strong representations against lookthrough due to the distortions it could create between smaller and larger companies. These are major issues well beyond the scope of this exercise[18].

[18] Aspects of the small vs large company taxation question are being considered in the current OTS review about ways to simplify the Corporation Tax computation.

3.6 **We can see considerable merit in a long range, strategic review of taxation in this area, to look at the whole question of how labour income should be taxed and whether capital returns should be taxed differently.** This could result in a framework for small business taxation, bringing greater certainty to the direction of tax policy – a constant call from business, as the OTS has often recorded. The changing nature of the economy, with the growth of the gig/sharing, makes this increasingly in point. The OTS would be pleased to participate in such a project but it would need to be considered jointly by HM Treasury, HMRC and perhaps the Department for Business, Energy and Industrial Strategy.

A Summary of comments

Summary of comments against discussion questions

Within the discussion paper we posed 12 questions, generally of two types. Some were high level questions regarding the suitability of lookthrough as a tax simplification device (questions 1, 2, 3 and 12). Others were technical questions about how specific aspects of lookthrough would work (questions 4-11).

Our aim was to stimulate discussion rather than generate exact answers to all the questions posed and most people we spoke with or received comments from did not attempt to answer all the questions. Here we give a summary of the 'answers' to the questions that we distilled from the input we received.

Question 1: *Do you agree with the five key issues above? If not how would you change or add to them?*

The five issues we had focussed on were endorsed, though it has to be said most wanted to cut through the technical issues within the questions and get to what they saw as the heart of the matter – would companies within lookthrough be disadvantaged by the system applying.

In that vein, more than one respondent pointed out that the government is deliberately reducing the rate of corporation tax and so increasing the differential between that and income tax for businesses. That sends a message that using a company is good: wouldn't lookthrough run counter to that?

Question 2: *Do you agree with the OTS's conclusion from the small company taxation review of the characteristics of companies that could materially benefit from the simplification offered by lookthrough?*

There were not many clear answers to this question as most worried about whether one could define affected companies sensibly. Others were just opposed to the idea in general so didn't want to engage on definitions. But there were few challenges to the OTS outline.

One association did suggest that lookthrough might be suitable for umbrella company users. A lot of it came down to '…sole traders who operate in company form…' but it was difficult to define such entities precisely. Single shareholder companies would be one way of targeting the system, but if that was used, it opened up obvious easy avoidance routes.

There were some responses that pointed out that if a business wanted tax transparency coupled with limited liability, they could use an LLP. Why, then, was lookthrough being offered as an option when if the business wanted to achieve that result, they had a route? One submission referred us to the German tax-transparent corporate structure *Unternehmergesellschaft (UG)* as a possible model for a single member company. The idea of amending the LLP rules to allow single member LLPs is something a number of respondents to our parallel SEPA review have suggested as a better way forward.

Question 3: *Do you think lookthrough would have an impact on growth companies if applied to them? If so, how?*

The resounding answer was 'yes'. Lookthrough, because it would tax all profits at (potentially) 40% + 2% instead of the CT 20% (reducing to 17%) rate would reduce funds available for investment. The annual investment allowance wouldn't be a full answer as many small businesses would save for more than one year to buy new equipment. Many made the point that this wasn't just buying equipment (namely capital expenditure); it was also funding working capital. Nor was this just a 'growth company' issue: many small businesses that just wanted to continue to trade would need to invest and that investment would be hindered with lookthrough.

This was probably the biggest area of concern/objection to the lookthrough idea.

Some also stressed that retaining funds in the company was often done to smooth income; to have money for a 'rainy day'; to cover holidays and extended breaks. All would be affected in terms of the amounts available under lookthrough. One specific area we were referred to was hospital consultants, who routinely use a company to carry out their additional work with a view to smoothing their income: it was suggested lookthrough would make them less interested in doing such extra work. We also were given a good practical example from a company that was in effect the family pension fund: its investments and profits were to be drawn on by the shareholders in due course but in the meantime salaries needed to be paid to reflect contributions but most funds were rolled up to be drawn later.

Question 4: *Leaving aside your views on whether lookthrough is a good or a bad idea, should the target group of companies be defined according to a turnover limit like the cash accounting limit? Or are there other methods that would better target a group of potential lookthrough companies? Do you think lookthrough should have a limit at all?*

There was a fair amount of support for the current cash accounting threshold, such as the VAT registration threshold. One submission suggested the income tax higher rate threshold, so c£43,000. But some wanted it to apply to 'no employees' companies, some to 'single owner' companies; some didn't want any limit as an optional basis would mean it was sorted out by choice. There was also an argument put forward that this was a question of the type – or business sector – the company was involved in, namely that it was all about service businesses that wouldn't need to retain income for investment. Companies not requiring funds for investment were the type we had in mind when we framed the continuation project but defining such businesses did not prove easy – most went back to the turnover criterion. However, in doing so, some argued for assets to be looked at as well or simply reminded us that turnover was not a good indicator of profit.

There were some suggestions that using the close company definition had some logic. Indeed, to many older practitioners, lookthrough had strong overtones of close company apportionment[19].

[19] This system allocated profits of a small company to shareholders when there had been insufficient distributions. The mischief being tackled was that retaining profits in a company sheltered them against higher rates of tax on dividends and so it was in the nature of an anti-avoidance measure rather than a simplification. The apportionment calculation was involved, with allowances for 'estate and trading' companies (and later no apportionment of such types of income) as a proxy for allowing funds to be retained for investment. The process was involved and led to some disputes though it was fairly stable and well-known so was manageable. It was abolished as increasingly obsolete in 1989.

The answers to this question have to be balanced with the answers to question 9 (optional or compulsory). Many 'solved' the question of how one could define the target group by saying the system should be optional – and so the target became self-selecting with no definition needed.

Question 5: *If allocation is made, should salaries be added back or left to stand?*

No clear consensus but slight majority of those who expressed a view said that if salaries had been paid (to owners) and PAYE accounted for, why go to the bother of adding back? It would potentially mean complex calculations and set-offs to offset PAYE deducted against income tax due on the allocated profits. There would also be NIC issues: class 1 on the salaries would stand rather than class 4 on allocated profits. .

Against that, a large minority argued for ignoring salaries and so in effect adding back any that have been paid and getting to a 'clean' allocation of income. If lookthrough status was known, PAYE/NICs on salaries paid could potentially be ignored though that may raise concerns about whether money would be available to meet future tax bills.

Question 6: *Are there other significant 'other issues' that need to be considered beyond the five noted above?*[20]

There were a few suggestions that including investment companies would be particularly problematic: how would they build funds for further investment which inevitably took time?

The biggest issue in this area (which linked to the salaries question) was when profits of a company are allocated partly by salaries, partly by dividends, to recognise the differing contributions made. Often this is how older-established businesses manage having founders who are now contributing much less than the second generation who are now doing most of the earning of profits. Lookthrough would significantly distort this management. It was also noted that in some cases family businesses that had distributed shares widely among family but didn't normally pay dividends, basically rewarding via salaries/bonuses, would end up allocating profits to all family members, including children[21]. How would they be given funds to pay the tax (though it was noted that in some cases that could reduce the tax bills overall as profits could well be allocated to low income members of the family)? In this context, some noted that minority shareholders could be faced with tax bills but not be able to obtain the funds from the company.

One important issue that came up a number of times was IR35. Some comments to the first stage of the OTS's work had suggested that lookthrough would 'solve' IR35, i.e. that it would mean that profits of the business would be allocated to the individual owner(s) and taxed as self-employed income (with just Class 4 NICs). But as the OTS noted, although that is the starting point, the company would not be subject to employer NICs as is the case with IR35. IR35 status is also dependent on the working relationship and ignores the corporate structure

[20] The five issues noted were:

1. preference shares: would dividends on them stand;
2. interest on directors' loans;
3. what sort of return or schedule would be needed to do the allocation;
4. benefit-in-kind given to proprietors (e.g. a company car): would these be in effect ignored and so regarded as taxed under sole trader rules;
5. We have designed lookthrough with trading companies in mind. But would we want to exclude investment companies? If so, how would one test to exclude investment companies while minimising complexity?

[21] It was suggested in a couple of meetings that this had implications for the Settlements legislation, though our immediate reaction was that the issue is already there with the share structure.

so it could not mean that the contractor who used a PSC was guaranteed not to be subject to IR35. It would have to be open to HMRC to investigate to see if IR35 applied.

We had a number of comments reiterating that IR35 would presumably still be in point and this fact clearly diminished enthusiasm for lookthrough.

We were asked whether there would be protection for creditors under lookthrough in some way. Would it affect their abilities to claim against the company? On the surface there didn't seem to be much difference in that the company could pay dividends/salaries now and leave little for creditors but an insolvency expert did suggest that lookthrough would mean extra rules would be needed in insolvency situations.

Question 7: What other types of income do we need to consider for lookthrough?

Question 8: Do you agree with the outline treatments above or do you have any suggestions on how they should be treated differently?

The OTS's listing was endorsed but comments were mainly around the difficulties that lookthrough would generate with these areas. Taking the list in the OTS's paper:

- Trading profits: the need for an adjustment of profits exercise, but now to 'unincorporated' rules, would add complexity and administrative effort. One issue noted was around R&D: would the credit still be available to the allocated profits? There are other allowances available to companies but not to unincorporated businesses: fairness would suggest that the rules for all of these would have to be amended to allow the shareholders to have the deductions on allocated income.
- Capital allowances: how would AIA work if the owner(s) had other businesses which also invested?
- Other income: the interaction with the new dividend allowance and personal savings allowance would potentially add complexity.
- Capital gains: this raised a lot of debate with many pointing out that fairness would mean that the gains allocated to the shareholders would have to be eligible for rollover relief and substantial shareholdings exemption, if they would have been so eligible in the company, implying complex additional rules. The fact that the shareholders may be able to use their annual exempt amount was noted as helpful but would the gains be subject to indexation? And of course the differing rates of CGT would be in point.
- Losses: the OTS had noted losses as an area of potential complexity; most who commented feared that if losses were allocated in a lookthrough calculation, there would then be further anti-avoidance to negotiate. Similarly, if the owner had losses perhaps from another activity, would they be available against lookthrough profits?
- Benefits to proprietors: what if the benefits were being payrolled under the new rules? Would that have to be unwound? How would private use be dealt with? What is the company transferred an asset to the proprietor – does that just get ignored under lookthrough?
- Expenses: what rules would be used for expenses (for example travel and subsistence) paid to worker shareholders?
- PAYE/NICS on salaries: as noted, most would leave salaries paid in place rather than adding back and carrying credits for PAYE/NICs, but the 'maximum NICs' issue was noted as adding complexity.
- Paying the tax: would shareholders have rights against the company to reimbursement for tax paid?

As well as the OTS list of technical issues, commentators added;

- **Double taxation:** there would presumably have to be some careful override rules to ensure that lookthrough did not tax the same profits twice. This would mainly be a timing issue: profits being allocated in one year then being paid out the next year, not necessarily as dividends. What would happen if the profits were used to pay rental to the proprietor for a property occupied by the company?
- **Double tax relief (DTR):** how would lookthrough tax be regarded in double tax agreements and when it came to DTR? And would relief for overseas tax incurred by the company follow into lookthrough?
- **Preference shares:** one commentator suggested that any such dividends should be respected unless they went to spouse or child when existing settlements rules might be relevant and leave the amounts used for the dividends potentially allocated under lookthrough.
- **VAT:** if this is to continue to be accounted for by the company (which most people saw as obvious) it does mean the company cannot disengage from tax compliance. On a computational point, if there was irrecoverable VAT in the company, that was assumed to be deductible in the profits computation for the company and hence in the allocation under lookthrough.
- **IHT** could be an issue where transfers of value were made by a close company and allocated to owners.
- **Payments to shareholders:** what happens where the company pays rent to the owner for a property used by the business?
- **Tax credits[22] and student loan repayments** could be affected and would need rules devising: would lookthrough profits 'count' for these? What would be the taxpayer's income and importantly how and when would lookthrough profits be taken into account.
- **Mortgages:** one contributor pointed out that mortgage lenders would have to develop rules for dealing with lookthrough but how different these would be to existing rules for small company proprietors is uncertain. Another suggested that lookthrough would be easier for mortgage providers to assess rather than less certain dividends.
- **Gifts to charities:** if the company made donations, how would these be treated under lookthrough – would individual gift aid rules now apply?
- **Pension contributions:** if contributions are made based on salary, would allocated profits under lookthrough be taken into account? If salaries were written back under lookthrough there would have to be rules that did not disallow the pension contributions made on the basis of salaries.
- **Non-resident shareholders:** how are they dealt with?
- **Would the 5% allowance for business admin costs under IR35 apply** under lookthrough?
- **Construction Industry Scheme:** a company may be registered for CIS; would that registration carry over to the individual(s) and if so would the applicability change at all?

A number of people acknowledged the potential simplification of not having to worry about tax consequences of **directors' loan accounts**. There would need to be some rules framing for these

[22] It has been pointed out to us that in some 'own company' situations, benefits can be calculated on a 'lookthrough' basis.

but in principle it was assumed these would simply be ignored for tax purposes. However, the issue would still be relevant for legal purposes: one submission from an insolvency expert suggested that lookthrough would result in more overdrawn accounts under lookthrough.

Question 9: *Do you think lookthrough, if it is introduced, should be optional/default or compulsory? Do you have any further points for your preferred route beyond those mentioned above?*

This aroused a good deal of debate, as we expected. Most wanted lookthrough to be optional, which would ensure that those who needed to retain funds would not be in danger of being affected. In effect that was the only realistic was of identifying the target market without capturing companies that didn't fit the suitability criteria. Indeed, one submission suggested that lookthrough should be introduced for a period – say five years – and then evaluated to see who had opted into it. Lessons could then be drawn as to how it could be extended (or of course dropped). One or two suggested that opting in to lookthrough might have to be for a minimum period rather than it being an annual option but most seemed to want it to be an annual choice.

Those that went for compulsion did so largely to ensure simplicity: no need to do calculations whether it was 'worth it'. Indeed, most recognised that an optional system could be unattractive to the Treasury as it would become a tax saving consideration.

One person, whilst recognising the extra complexity of testing whether lookthrough was worth it, suggested that it should be compulsory with an 'opt out'. This would presumably be intended as a simple process based on likely investment and so need for the funds; it could be a case of 'by inspection election' rather than 'by calculation proof'.[23]

Question 10: *Would cash accounting be a useful simplification for lookthrough companies?*

Question 11: *Would cash accounting be useful to companies even if they still had to produce a corporation tax return?*

The majority agreed that cash accounting could be a useful simplification for small companies. It might be a useful by-product of lookthrough. But some were very much against cash accounting being extended, arguing that companies need 'proper accounts'. In many ways this was a re-run of the debate around cash accounting from when the OTS recommended it be introduced for unincorporated businesses. The difference was the backdrop that companies have to do 'GAAP accounts' under current legislation.

Many of those who wanted to preserve GAAP accounts accepted that the classic PSC did not need full GAAP accounts, but naturally stressed the need for some accounts to be prepared. Partly that would ensure that company and individuals were demarcated. We were also reminded that cash accounting as enacted was not as simple as it could be, some referring to interest restrictions.

This all led to one of the regular points in our discussions: that lookthrough would not eliminate the need for the company to prepare and file accounts in some form. As that was the case, how much simplification would lookthrough really deliver?

[23] This has some overtones of electing to reduce payments on account (POA) under income tax self-assessment. The taxpayer does not have to provide a calculation but is still expected to put in a figure for the POA. HMRC simply accept the reduced figure but are likely to question it if later it transpires that the taxpayer had a significantly higher liability after all.

There was another accounting point raised: how would lookthrough get reflected in the accounts?

One submission raised the interesting idea that a company subject to lookthrough should be exempted from company law compliance requirements or (more likely) qualify for a simplified version of the standard filing requirements.

Question 12: *What do YOU think? Can lookthrough deliver simplification?*

We had some very thoughtful comments to our overall question (and some slightly emotive ones!). Many made the point that they could not see that lookthrough would mean their being able to dispense with a tax adviser – as in most cases the CT calculations and compliance was a simple by-product of the accounts work. As one put it:

"I really cannot see how the owner of a small company would find it any easier to keep their affairs in order – with or without the services of an accountant." (Proprietor of a small company)

Some of the later discussions raised the issue of Making Tax Digital (MTD): how would lookthrough fit into that? In principle the four annual updates would apply to the business in any event, but the assumption was under company procedures rather than unincorporated.

It has to be noted that we had some comments to the effect that MTD was quite enough change for small businesses, incorporated or not, to cope with at present.

Admin burdens

One of the drivers for lookthrough was whether it would save administrative effort (either directly for the company or for advisers, resulting in lower fees for the client). We had a regular series of comments to the effect that corporation tax compliance was a simple and low cost service. As one trade body said in a meeting, their clients get a 'care package' and corporation tax compliance was simply a component. The view of one professional body was that any complexity for small companies came from the matters beyond CT such as benefits in kind.

One association felt lookthrough would result in increased fees, although they also suggested that it would be relatively easy to develop a software package (presumably as an add-on to other packages) to do lookthrough calculations and allocations.

A few respondents suggested that the real admin saving would come from harmonising accounting and taxable profits. That would simplify much and also make MTD easier.

If no corporation tax computation was required, almost everyone pointed out that a similar computation would still have to be carried out to arrive at profits that would be allocated under lookthrough. Most of those allocated profits would be making income tax returns already so they would have different figures to put in them from the current dividends/salary but there was minimal additional burden. There would be some cases of people being drawn into the income tax self-assessment system by lookthrough but probably not many who would thus be facing a significant extra compliance burden.

We had a number of references to lookthrough in other jurisdictions, as had the OTS in its initial report. We were reminded that in some countries lookthrough can **reduce** tax bills. A couple of people in meetings who dealt with US LLCs saw that this route could help UK resident non-doms who used LLCs as they would potentially be transparent (HMRC says they are companies).

Could lookthrough deliver simplification?

The overwhelming majority view of stakeholders can be summed up in one word: No. Reasons were many and varied but points made frequently were:

- Corporation tax is well established and relatively easy for small companies as a by-product of the need to do accounts; those affected would still be faced with full 'adjustment of profits' so the admin saving is modest;
- The damage to investment and flexibility of conducting business;
- Optional lookthrough would be possible but compulsory impractical in terms of capturing the target group we identified;
- The need for vastly complex rules to deal with all the specifics noted in response to question 8.

It is interesting that some suggested that the way to help a small company that found corporation tax too difficult was to improve disincorporation relief so they could in effect opt out without the need for the complexities of lookthrough.[24]

[24] That would of course mean they lost limited liability protection but moving to LLP would be possible.

B Contributors and acknowledgements

As with all of the OTS's work, we have gathered evidence to support our work, as well as carrying out our own researches. Our main report generated a useful amount of comment and following publication of our interim paper we had had a good number of responses to some or all of the issues we raised. We have talked extensively to members of our consultative committee and have carried out a limited number of meetings with interested parties, though given the timescale and restricted nature of the project we have not carries out as extensive a series of meetings as we did for the initial Small Companies report.

We are confident we have gathered sufficient evidence to support our conclusions and are very grateful to all of those who have taken the time and trouble to write to and meet with us. This includes especially our consultative committee members, the Federation of Small Businesses (who organised a series of four workshops around the country) and some individuals who, having written it to express views, responded well to being contacted and asked for further thoughts!

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As always, we apologise to anyone we have inadvertently omitted from the above listing.

We should also acknowledge with thanks the various articles and commentaries in the professional press on lookthrough, including CCH, Taxation, Tax Journal, Tax Adviser and Accounting Web. We have read them all with interest.

C Extract from the March 2016 Small Company Taxation report

The OTS's report published on 7 March 2016 included the following recommendation, which was accepted by Ministers:

The OTS develops an outline lookthrough system of sufficient detail to generate proper debate. This would target a range of companies that:

- *do not intend to increase in size*
- *are effectively one-person businesses*
- *distribute all (or almost all) their profits*
- *have few assets or need for investment funds*

The design should be of sufficient detail to generate proper debate.

The summary within the report on Lookthrough was as follows:

A lookthrough 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 lookthrough. 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 lookthrough. 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 lookthrough 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 lookthrough taxation system that ultimately puts them in the simpler sole trader tax system. Thus simplification was the main reason for people supporting a lookthrough approach. There was also strong support for lookthrough, 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 lookthrough 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 lookthrough 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 lookthrough 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.

1.46 In principle, the OTS can see that a lookthrough system offers scope for simplification. Lookthrough 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 lookthrough 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 lookthrough 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 lookthrough 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**
- **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