Office of Tax Simplification

Office of Tax Simplification
Room G 41
1 Horse Guards Road
London SW1A 2HQ

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Lookthrough taxation

A discussion paper

This paper further develops the lookthrough taxation model that was mooted during the OTS's small company taxation review.

Introduction

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. There is no strict formula available to evaluate the two and we will weigh up both as we consider the merits of different approaches to lookthrough. Our evaluation of lookthrough will be focused on simplification and in essence we pose and will answer the question:

Will a lookthrough system of taxation provide a simpler tax system for those taxpayers affected?

In the OTS's Small Company taxation report[1], we looked carefully at lookthrough and talked to a lot of people about it. We found some strongly in favour – but also some strongly against. As our report set out, although eliminating the CT computation and return is useful, there would still be a need to do a taxable profits calculation; all the accounting and regulatory aspects are still there for the company; all profits would be taxed in full which potentially harms investment (though the Annual Investment Allowance must not be forgotten); and, if lookthrough is optional, that may simply mean more advice is needed and it just results in a 'lower tax' option which would be taken up only by those who would gain a tax benefit from it.

Consequently we concluded that lookthrough would not be a general simplification but that we could see some possibilities for a subset of companies that didn't retain funds. This paper develops our thinking and poses some questions for interested parties.

Objectives of this paper

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

We plan to publish our conclusions on lookthrough in October. As always with OTS projects, we welcome comments at any time but would prefer responses to this paper by 12 September if possible though our absolute deadline is 30 September.

Please send comments to: ots-smallcompanies@ots.gsi.gov.uk

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

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[1] Published on 7 March: https://www.gov.uk/government/publications/small-company-taxation-review

What is 'lookthrough'?

Lookthrough taxation is a way of taxing small companies and their owners that allocates the profits (including all income and gains) of the company to the proprietors. For tax purposes, the company is ignored (so no corporation tax) and instead the owners are taxed directly on the company's income under income tax and CGT rules.

This would mean the shareholders being charged income tax and Class 4 national insurance contributions (NICs) on their share of the profits. No further tax would be due when dividends were payable, as the profit share would already have been charged. The treatment of salaries paid to the proprietors is discussed below.

As the proprietors will already be subject to income tax/NICs, on the surface there seems a real simplification: there would be no need to worry about corporation tax, a tax that from our research causes difficulties and is usually outsourced.[2] It may also go some way to ensuring that businesses and companies whose operations are comparable from a commercial perspective are also taxed in a comparable way.

Lookthrough only affects the taxation of the company's results: the company remains in place, with all its consequences, for general law purposes and for other tax matters such as VAT.

Key issues

We think there are 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?

We are aware that lookthrough is seen by some as a route that might improve overall compliance and in particular assist or obviate the need for IR35. However IR35 is legislation that is concerned with circumstances where a company's income is to be taxed as the proprietor's employment income. This is broadly where the proprietor would be taxed as an employee of their client were they engaged directly by the client. Lookthrough would not change this.

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

Who would lookthrough apply to?

All companies could technically gain some benefit from the simplification offered by lookthrough, but the Small Company Taxation review suggested that there is a cohort of companies that could materially benefit from it. These were companies that:

- generally 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.

A key argument made by some respondents against lookthrough is that since it will tax all profits, rather than extracted profits, growing companies will have less money to invest. Revenue expenditure will still

[2] Chapter 4, OTS Small Company Taxation Review, March 2016

remain tax deductible under normal rules and lookthrough companies will still be able to make use of the annual investment allowance (AIA), so this may be more of a cash flow or timing issue.[3] This is still an important observation and we will work with the relevant Government departments and stakeholders to try to ascertain the impact of lookthrough on growth companies. However an HMRC research report[4] found that 62% of non-employing companies did not expect to grow so there is still scope for a large proportion of the micro-company population to benefit from the simplification offered by lookthrough when weighed up against any potential tax increases.

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?

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

Lookthrough is targeted at micro companies and we have not identified a sufficient reason why larger or growing companies would want to use it. Whether lookthrough is optional or compulsory, we think it is sensible to define and limit its application to protect against abuse. In order to maintain simplicity, that probably means a monetary limit, and one that is already in existence. It could be set at the current tax cash accounting for small business threshold (the VAT registration limit) or if a larger figure is required, the VAT cash accounting threshold (VAT taxable turnover of £1.35m).

A hard ceiling has the potential to cause distortionary behaviour, with businesses reducing trade to remain under the lookthrough ceiling. The effect of this could be partially reduced by implementing a multi-year rule, e.g. companies must leave lookthrough only if they have two or more years outside of the qualifying criteria. However, the impact of this would have to be explored further.

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?

How would it apply?

Lookthrough would allocate the company's income to the proprietor(s). This means all the company's profits and thus it means allocating not only trading income, but also investment income and also any capital gains, calculated in the same way as for an unincorporated business. This would mean that these companies are no longer required to complete a corporation tax return.

The allocation would be in proportion to shareholdings. Dividends would be ignored.

Many companies will pay salaries to the proprietor(s). If lookthrough applies, these would have to be taken into account in a way that avoids double taxation. This could be either:

- writing back salaries paid, and allocating profits before salaries

[3] Clearly if a lookthrough company earns 100 in year 1 and invests that 100 in plant in year 1, the AIA will ensure that the net taxable profit allocated is nil. The potential problem arises if the company wants to save Year 1's 100 and add it to 100 made in year 2, planning to invest 200 in year 2. Would lookthrough mean that year 1's 100 is taxed at (say) 42% and thus not wholly available in year 2? Or would the 200 year 2 investment generate a carry back to eliminate the year 1 lookthrough tax bill?

[4] Ipsos MORI HMRC Research Report No 390 (September 2015): Profit Distribution and Investment Patterns of Unlisted Companies.

- accepting salaries paid and allocating profits after salaries.

The second route would in principle be simpler as it requires fewer processes.

There are a number of other issues that will need to be considered, such as:

- preference shares: would dividends on them stand;
- interest on directors' loans;
- what sort of return or schedule would be needed to do the allocation;
- 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;
- 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?

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

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

What tax consequences would ensue? How would it be implemented?

Calculating the amount of corporation tax due is relatively simple once one has completed the company accounts – at least according to many advisers. However, both small company owners and advisers told the OTS that various complications arise – directors' loan accounts and expenses (anything involving P11Ds) being the main two, with drawings by the proprietor without proper accounting being another regular issue. This means the reality of living with corporation tax is far more complicated than initially appeared.

Under lookthrough, the owners are allocated various additional amounts of income and gains, to be treated as theirs for tax purposes. Our initial thoughts are that these would in principle be taxed in the same way as if the individual were a sole trader (or partner if there are multiple shareholders) with various consequences:

- ***Trading profits***: this would need an adjustment of profits exercise in the same manner as for an ordinary sole trader, including capital allowances computation. The taxable amount would then be subject to income tax and Class 4 NICs.
- ***Other income:*** rentals, interest, etc. would be subject to normal income tax and no NICs.
- ***Capital gains*** made by the company would be treated as if made by the individual, therefore allocated to the shareholders who would then pay CGT at CGT rates if their total capital gains from all sources exceeds the annual exemption amount. Rules regarding rollover relief would continue to apply to each shareholder, taking their capital gains from all sources into account.
- ***Losses*** would have to be available for offsetting as under self-employment. So, for example, a trading loss would be allocated to shareholders in the same way as a profit and be available for offset against shareholders' income from other sources, thus reducing their income tax bills. If shareholders had brought forward CG losses they could be used against allocated CG profits from the company, similarly brought forward trade losses could be used against allocated profits from the company from the same trade.
- ***Benefits given to proprietors:*** as noted above, the BIK rules would be ignored and, to use a company car as an example, the car would be treated as the proprietor's under self-employed rules.
- ***PAYE/NICs paid on salaries:*** if salaries are written back so 'gross' profits are allocated, any PAYE and NICs already paid would have to be refunded or (simpler) treated as a credit/payment on account for

the proprietor's tax/NIC[5] bills. If salaries paid are allowed to stand, any NICs paid on them will have to be considered in a 'maximum NICs' calculation.

- ***Paying the tax:*** as the income has been allocated to the shareholders, it would be for them to meet the resulting tax liabilities rather than have the company pay.
- ***Tax returns:*** presumably there would be no requirement for a return by the company but the proprietor(s) would include the income and gains in their returns under ITSA.

One of the arguments against lookthrough is that shareholders would be subject to higher rates of tax than the company. However, as noted in the Small Company Taxation report, the introduction of the new dividend tax has eliminated some of this differential.[6]

There are some wider considerations:

- VAT: if the company is registered for VAT, would that be affected at all by lookthrough? It would seem to be simpler to leave VAT alone.
- Expenses: would there need to be any adaptation of the expenses rules as the intermediary (the company) is being ignored for direct tax purposes?
- Would all corporate CGT reliefs apply such as substantial shareholdings (SSE)? Although unlikely to arise, SSE needs to be considered.
- Similarly, what of reliefs only available to companies and not to sole traders or partnerships (e.g. R&D)? Should these be available, as the expenditure is by a company? Or not because the entity is not being taxed as a company?

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?

Optional or compulsory?

There are two broad approaches for implementing lookthrough taxation. An **optional** (or **default**) model will give companies the choice directly (or via an opt-out) about whether they wish to be a lookthrough company. This has the benefit of being self-selecting – only those that are likely to benefit from lookthrough taxation, i.e. the simplification is deemed more valuable than any increase in tax, will become lookthrough companies. However, it will inevitably mean that whether or not to opt for (or opt out of) lookthrough will become part of tax planning and so companies within its ambit will end up taking additional advice from their advisers.

One response to this would be for the option not to be an annual choice but either a permanent one or for a set period. That would stress that it is intended as a simpler set of procedures; but it may be that few businesses would then want to lock themselves into it.

The other approach is to make it **compulsory** for companies that are within scope. This would be simpler (choice brings complexity), although whether that added simplification is justifiable will depend on whether those caught are likely to benefit from the simplification of lookthrough when weighed up against the costs.

[5] Any NICs paid on salaries would of course be Class 1 whereas NICs due on the allocated income would be Class 4. Rules would have to be framed to permit a simple offset without regard to the differing classes rather than requiring repayments and payments which will strike taxpayers as unnecessary.
[6] See, for example, the analysis in Annex D, pages 101-106 of the Small Company Taxation report.

It would also protect exchequer revenues and help ensure that small companies and businesses conducting the same activities are taxed comparably.

The main risk raised during the Small Company Taxation review was that a compulsory model will capture some businesses that would be adversely affected by lookthrough (e.g. if they wish to retain funds for investment). A new small company could automatically be put into the lookthrough system without having further options to weigh up. However, that would mean that a company formed with a view to growing and so needing to retain funds would also be in lookthrough. If this risk holds, it suggests a need to be able to have some form of escape clause if investment can be demonstrated; but defining that may be complex.

The total impact on investment may be muted somewhat. Revenue expenditure will still be tax deductible and the £200,000 AIA limit would be expected to cover the capital expenditure of the vast majority of lookthrough companies.[7] But cash flow/timing may be an issue[8].

There is of course a hybrid option where lookthrough was compulsory for part of the population and optional for others. However, in trying to *simplify* the tax system we consider this an unhelpful complication.

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?

Other issues

Accounting treatment

Lookthrough is concerned only with the tax treatment, so the accounting requirements will remain the same as they are for existing companies. Any company within the ambit of lookthrough will continue to prepare accounts on a full accruals basis.

Lookthrough could present an even greater simplification if it were combined with cash accounting. Cash accounts are significantly simpler than accruals accounts, and while they may not provide as much information, they have proven sufficient for the 1.1million small unincorporated businesses that have opted to use them.[9]

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?

Legal treatment

Lookthrough does not affect the legal status of the company to which it applies. Therefore all existing and future company law would apply to lookthrough companies exactly as it does to any other company.

Summary: would this deliver simplification?

We start the summary by reiterating our overall question:

Will a lookthrough system of taxation provide a simpler tax system for those taxpayers affected?

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[7] The AIA would not of course cover expenditure on land and buildings but very few of the sort of small companies that lookthrough may affect will have such capital expenditure.

[8] See footnote 3 above.

[9] HMRC data

As far as the OTS is concerned, this is the question we have to answer in our final report (planned for October). We can list some pros and cons from the analysis we have carried out so far:

- It has the potential to offer a simplification because of factors such as:
    - There would be no corporation tax calculations or compliance to worry about;
    - There would be no unexpected tax consequences of drawings/directors' loans;
    - There would be no dividend taxation;
    - It would result in a simpler calculation of tax against benefits such as company cars;
    - It would be simple if compulsory.

- However this has to be weighed against the downsides including:
    - Still having to do the same adjustment of profits exercise as under CT;
    - There may be a need to adjust aspects of salaries;
    - It is possible that an 'allocation' return is needed;
    - An optional basis means more complexity and advice;
    - An optional basis risks exchequer costs and may mean minimal take up;
    - Bringing in a new set of rules undoubtedly adds complexity and risks confusion;
    - Paying the tax due may be cumbersome;
    - Careful rules would be needed to cover all types of income, together with losses, expenses etc. and considering the various rules/reliefs specific to companies.
    - Some companies trying to build investment funds through retained earnings could be adversely affected, unless a simple investment relief system can be devised.

There are a variety of risks inherent in introducing a lookthrough basis. These include:

- ***Uneven tax burden:*** Lookthrough would tax some companies more heavily than others but it does potentially level the tax burden between some companies and unincorporated businesses.
- ***Administrative burden:*** Will the lookthrough basis produce a net admin saving for affected companies?
- ***Presentational risk:*** Lookthrough, especially if compulsory, could be seen as a method for increasing the tax paid by small companies, while leaving larger companies to continue to pay less tax in the current corporation tax system. This could be balanced against the current system being considered unfair on sole traders who may do the same business in same way but not be incorporated, are so are subject to higher tax.
- ***Lack of adoption:*** If the system were optional, would it be used sufficiently to justify its introduction?
- ***Complexity of change:*** Lookthrough must provide sufficient simplification to enough people to warrant its introduction. A key OTS finding, regularly reinforced in our reports, is that the mere act of introducing anything new to the tax system adds a degree of complexity in itself.

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