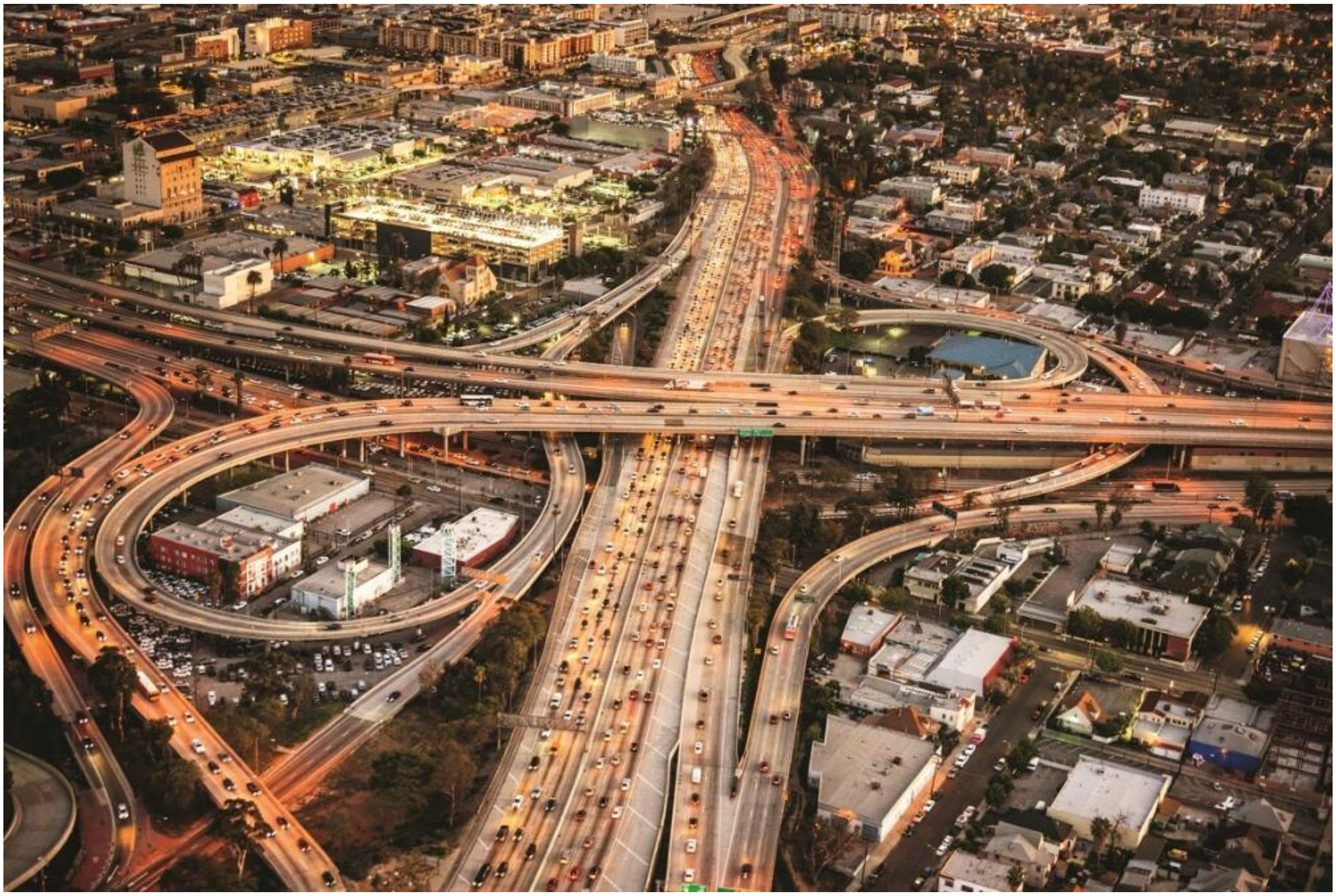
Alternate routes

OMB



01 February 2017

John Whiting provides a summary of the OTS's work on the options for simplifying small company taxation

Key Points

What is the issue?

The OTS recommends taking forward a new way of sole traders gaining some liability protection ('SEPA') but thinks a 'lookthrough' taxation system would not simplify tax for small companies and so does not recommend it be pursued.

What does it mean to me?

SEPA will take time to fully evaluate so do have a look at the OTS report and contribute to the further discussions. And in the meantime do chip into our corporation tax, VAT and (paper) Stamp Duty projects!

What can I take away?

The value of contributing to the OTS's work – as always recommendations are based on evidence gathering among businesses, advisers and other interested parties, together with our own researches.

Simplifying taxation for small businesses has been a major focus for the Office of Tax Simplification (OTS) throughout its existence. We did a series of reports around small businesses in our early days; then looked at partnerships (large and small); and latterly have looked at small company taxation. If that begins to sound like a trilogy, maybe the analogy with certain filmic epics is strengthened by the way that these projects have had a habit of lasting a long time and themselves extending to multiple sections.

Our Small Company taxation report was published in March 2016. It contained 13 recommendations and found favour with Ministers as six recommendations were accepted and six marked for further consideration. (The one rejection was for a long term study of an alternative basis of taxation for small companies – bear that in mind towards the end of this article.)

Two accepted recommendations were for further work on interesting ideas:

- A new form of trading arrangement, christened Sole Enterprise with Protected Assets or 'SEPA';
- A lookthrough basis of taxation, i.e. a system that would tax a company by assessing the shareholders on its results and ignoring the company.

We put out discussion papers on these topics in the summer and the core question we set out to answer for both was: *would they deliver simplification?* Further glosses were added as we developed things, but that simplification goal remained the key.

It’s worth stressing that, contrary to what some people thought, we were not recommending these ideas in March – both clearly needed a lot more investigation first.

SEPA

What is a SEPA?

The idea of SEPA is that it would allow a sole trader to register for this status. In return, they would have a measure of liability protection: the main asset to be protected would be the trader’s home. So if the business went down, the home would be protected against business claims.

A SEPA would not have a separate identity: it would not be a new vehicle. This is important; it would not alter the tax (income tax, CGT or NICs) position of the trader, who would continue to be taxed as before.

Why consider a SEPA?

The idea of SEPA stemmed from our researches into reasons why people form a company. According to HMRC Research Paper 317 ‘Reasons behind incorporation’ (published in June 2014), the main reason is to obtain limited liability. Many we spoke to disputed this finding and asserted that tax considerations were the main driver: we of course fully accept that tax is a key driver but possibly agents who put that forward as the main reason should bear in mind that clients they see are likely to want to consider tax results! Be that as it may, limiting liability is undoubtedly an important reason, so offering a simpler route to achieve this had merit in the eyes of most people we spoke to.

Many pointed out that forming a company is a simple, cheap and established procedure. We agree – but just like the reminder that a puppy is for ever, not just Christmas, many find that keeping a company going becomes a burden and leads to problems. SEPA could obviate this.

How to register?

We were clear that SEPA had to be simple. It was axiomatic that there had to be a registration process and a public register. We refined the requirements as we developed our thinking and recommended that it would require lodging (possibly with Companies House):

- Name (and trading name if different)
- Trading address
- Address of the property to be protected
- Description of type of business
- Proprietor's NINO/UTR
- Declaration that the trader is eligible to register as a SEPA

This would produce a SEPA number and the trader would have to use this (and make clear the SEPA status, in the same way as 'limited' for a company) in their material. Some of the details of the SEPA – essentially the name, business address and SEPA number – would be on a public register.

Concerns and issues

A lot of debate about the SEPA idea ensued and we had some very useful submissions. The report we published in October sets out and addresses concerns and issues; some key ones were:

- ***If you register as a SEPA and so protect your home, you won't be able to get bank finance.*** Banks we spoke to didn't see this as a major issue as: (a) most small traders didn't borrow the sort of amounts requiring security; (b) if they were financing an asset, that would normally be the security; (c) a security over the house could still be taken with SEPA protecting residual value.
- ***Trade creditors will not deal with a SEPA and credit ratings will be damaged***: we spoke to a major credit reference agency who decided SEPA actually helped, compared with an unregistered trader – as the trader was now on a register and established. Similarly, trade bodies didn't evince concerns about trade credit.
- ***This would just cause confusion in the marketplace***: a fair challenge, but research, including an extensive survey by Screwfix (summarised in our report) suggests SEPA would be an easy concept to explain and understand.
- ***It wouldn't be used: we see a cadre of potential users*** – for example someone 40+ starting out in business after being employed. The 'gig' economy may also be relevant. Again, respondents to the Screwfix survey were positive with some 68% interested in the idea.

- ***What assets?*** Our recommendation is to keep the idea simple by just covering the proprietor's house. Some suggested that in these days of pensions freedom the pension fund also deserved protection: we don't disagree but it seems an issue to be explored generally rather than just in the context of SEPA.

Conclusion – and what's in a name?

This is not a 'slam dunk' but we do think the idea has merit, not least in encouraging enterprise (though the UK's problem seems to be more about keeping businesses going rather than establishing them). Accordingly, we recommended that SEPA be developed further and this has been accepted by Ministers, who have asked HMT, HMRC and BEIS to take the idea forward, doing more work on creditor aspects.

One point that will need consideration is the name as 'SEPA' also stands for Scottish Environmental Protection Agency and also Single European Payment Area. Personally I rather like Sole enterprise with Protected Qualifying Residence or SPQR…

Lookthrough taxation

Taxing the proprietor(s) of a company rather than the company itself has been an idea long discussed and is something that the CIOT suggested as worth examining when I first joined. Other countries (notably the USA with the 'S' corp) use it in one form or another, though most seem to result in lower tax bills.

Our review of the concept wasn't about lowering tax bills – indeed as many vehemently pointed out tax bills would rise as profits would be taxed in full at income tax rates plus NICs (as if we hadn't spotted it…in fact we noted it in our discussion paper!).

Would simplification result?

There would no longer be a need to do the corporation tax computation and compliance routines…and the proprietor(s) would probably already be doing their own tax returns. A lot of problems around directors' loan accounts would disappear. So on the surface that sounds promising, but:

- There would still be an 'adjustment of profit' exercise
- The company would still have to do accounts

- For most small companies, corporation tax is a relatively simple by-product of the accounts process
- Rules would be needed to deal with other income, losses, benefits etc.
- Capital gains would need to be apportioned…how would annual exempt amounts and reliefs such as rollover be managed?
- Cash accounting could be helpful for companies under lookthrough…but that is not possible under current rules.

Wider issues

Adding all these issues together gets to a clear impression of more complexity rather than less for many under lookthrough. But much comes back to that question of taxing everything immediately, with the risk that funds available for investment are reduced. A rejoinder is that in many cases the small company doesn't invest, so can such companies be identified? We could not develop a simple definition of such companies and as many pointed out, it wasn't just about retaining funds for capital investment: many proprietors wanted to retain funds in the company to cover downturns in business (or simply a holiday!).

How about allowing lookthrough to be optional? That appealed to some we spoke to but we concluded that would add complexity – as it would have to be evaluated with the business probably requiring professional support to do so. Hence it risks adding to costs and becoming a 'lower tax cost' option.

Conclusion – no but…

Our conclusion was that lookthrough did not offer a route to simplifying tax for small companies. Accordingly we did not recommend pursuing the idea. We did, though, observe that there was merit in a wide review of ways of taxing ways of working, which given the growth of the gig economy and wider ways of working is likely to become an increasing issue. This was picked up by the Chancellor in the Autumn Statement and HMT and HMRC are going to be taking forward work on different ways of working. The OTS conclusions on lookthrough will feed into that project.

And finally…

There will no doubt be further work on other aspects of our small company recommendations, so please do 'watch this space' and contribute. Meantime, we are well on the way to reporting on simplifying the corporation tax computation and getting going on VAT and (paper) Stamp Duty projects. Please do contribute: the tax system will never be simple but that shouldn’t stop us all trying to make it simpler!