



ICAS response to the OTS discussion papers:

**Lookthrough taxation and
Sole Enterprise with Protected Assets**

30 September 2016

OTS discussion papers: Lookthrough taxation and Sole Enterprise with Protected Assets

About ICAS

1. The following paper has been prepared on behalf of the ICAS Tax and Insolvency Committees and includes comments made during an informal meeting with John Whiting at ICAS on 6 September 2016.
2. The ICAS Tax Committee, with its five technical sub-Committees, is responsible for putting forward the views of the ICAS tax community, which consists of Chartered Accountants and ICAS Tax Professionals working across the UK and beyond, and it does this with the active input and support of over 60 committee members. The ICAS Insolvency Committee is responsible for considering proposed legislative changes together with technical and professional conduct standards in the area of insolvency and restructuring. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 21,000 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.
3. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. Evidence provided by ICAS aims to inform in a positive and constructive manner. ICAS is apolitical and will not take a stand for or against a particular political position. From a public interest perspective, our role is to share insights from ICAS members into the many complex issues and decisions involved in the design and implementation of fiscal measures, and to point out operational practicalities. Our representatives also contribute based on the collective experience of decades of work which ICAS members and staff have undertaken with both the UK and Scottish Parliaments and tax authorities, and other European and worldwide institutions, on a shared agenda that seeks better outcomes for all stakeholders.

General comments

4. ICAS welcomes the opportunity to contribute to the discussion papers on 'Lookthrough taxation' and 'Sole Enterprise with Protected Assets', which were published by OTS on 18 July 2016.
5. ICAS supports the work of the Office of Tax Simplification (OTS) and welcomes the fact that it is being placed on a permanent footing. ICAS looks forward to continuing to work with the OTS.
6. Detailed comments on both proposals are set out below.

Sole Enterprise with Protected Assets (SEPA)

Overview

7. From a taxation viewpoint, this proposal has the merit of simplicity. If it were to reduce the number of small limited companies, this would be a simplification.
8. From a business and insolvency point of view, there are a number of potential downsides, which are discussed below. Overall, how likely are the proposals to reduce the number of small limited companies and could the insolvency aspects be more simply covered by alternative proposals, such as the idea of a minimum 'protected equity in all bankruptcy proceedings'?
9. It seems unlikely that the complex position of employment intermediaries (IR35 rules and personal service companies) would be affected. Business and tax considerations suggest that SEPA is unlikely to be an effective alternative to incorporation in this market.
10. It is difficult to estimate potential take-up of SEPA. Those starting up in business may be influenced by a number of factors: market presence, taxation, financing, IR35 employment intermediary rules, and may be influenced by various sources of information such as Business Gateway, Chamber of Commerce, colleagues and associates, as well as advice from professional firms. They may already have decided on their business model and purchased an off the shelf company before taking professional advice.
11. Numbered questions are those set out in the Sole Enterprise Protected Assets discussion document at <https://www.gov.uk/government/consultations/sole-enterprise-protected-assets-discussion-document>.

Q1. Do you agree with this broad outline of the SEPA model? In particular do you agree with protection being only in terms of business debt? If not, what would be the most practical approach?

12. Protection for business debts only seems appropriate. From a practical angle, determining what to include as business debt may be problematic.
13. SEPA, as outlined, is a registration system. To what extent does it also create a separate entity, and for what purposes? For example, a partnership is a separate legal entity in Scotland, but not in England and Wales; yet both are taxed on the same basis.
14. There is a danger of creating a two tier society where the assets of 'traders' and 'non-traders' are treated differently for insolvency (and potentially for other legal purposes). There could be difficulty in determining the boundary here: how much trading would be needed to bring the protection of SEPA?
15. How would bona fide traders be distinguished from individuals who, for example, with insolvency looming, might start a small-scale trade, such as on ebay?
16. Most sole traders do not distinguish between themselves and their business. How is 'a claim arising from the business' defined? For example, the sole trader will use a personal credit card for personal purchases and business purchases – is a claim arising from that credit card a personal or business debt? If the sole trader has their business based at home, is a claim arising from unpaid council tax a personal or business debt?

Q2. Do you agree that only the primary residence should be protected?

17. The primary residence only should be protected. Measures would be required to prevent 'flipping' of homes, where an individual owns more than one property (compare issues around the main private residence election for Capital Gain tax).
18. This might be a risk, for example, where a trading debtor has a number of residences and there is significant equity in one property and minimal in the other. The issue could extend to property mainly used as a holiday home. Regular 'flipping' could frustrate legitimate

legal action. It might be necessary to consider registering SEPA property at the relevant Land Registry.

19. From a business angle, is it likely that banks, or significant trade creditors, would permit exclusion of the primary residence? If exclusion were to be mandatory, would this negatively impact the availability of finance to smaller business?
20. On the other hand, there are instances where individuals have been put off acquiring a business where it has been necessary to raise a loan and the lender required a charge over the matrimonial home.
21. SEPA may restrict access to credit or business funding. The removal of the single most valuable asset against which a debt could be recovered, is likely to impact on credit availability and the cost of credit for sole traders. This may result in an increase in sole traders being moved to pro-forma invoicing before supply of goods, or cash-on-delivery. This issue should be discussed further with banks and credit suppliers to understand the impact.
22. It seems highly likely that, unless prevented in legislation, banks and credit suppliers will write into terms and conditions provisions which will allow enforcement (England and Wales) or diligence (Scotland) against the protected property thus removing any benefit from SEPA.
23. This suggests that in order to provide for the protection envisaged, changes would be needed to the bankruptcy legislation in all UK jurisdictions. Bankruptcy is devolved to the Scottish Parliament. What are the views of the Scottish Government and what are the practical implications of having the amendments made to legislation in two jurisdictions? Other Scottish legislation would require amendment also to offer the envisaged protection, for example from inhibitions against property.
24. SEPA status may impact relations between traders and their customers. Some customers take note of a sole trader's potential asset backing; and having a property in the background can be a factor. It is not unknown for small traders to be without appropriate 'product' insurance cover; so asset backing is a form of assurance to some customers.

Q3. We have not proposed that we cap the value of the protected primary residence. Do you think this would be necessary to prevent risk of abuse? If so what would be a suitable cap?

25. A variety of opinions were expressed on this topic. If any value of residence were protected, this might seem unfair. Yet in terms of protecting assets, the ease of transferring assets to other family members suggests that no system is likely to be completely watertight.
26. A protected amount of say, £30 – 50,000 might help to reduce the social disruption of bankruptcy. If individuals are left with nothing, the social costs can be high; and access to housing in particular, limited.
27. An alternative approach would be to introduce a level of 'protected equity' which would apply in all bankruptcies, irrespective of whether the debtor is a trader or not.
28. This would ensure parity in treatment of individuals in bankruptcy, balances the risk/reward between the traders and their creditors and ensures that in the worst case scenarios a debtor would have equity to take forward for use either as a deposit for purchase of an alternative property, or towards renting a home, if the original property had to be sold due to bankruptcy.
29. Amendments could be made to diligence and enforcement legislation to prevent inhibitions/ charging against residential property for (wholly) business debts.

Q4. Are these qualifications and restrictions reasonable? Or would they damage someone's ability to get back into business after having problems? Are there any other individuals who should or should not be allowed to apply for SEPA status?

30. It seems fair for the individual not to have had the relevant restrictions lifted before they could obtain the benefit of SEPA status.
31. Eligibility criteria – If IVAs are included in the list of criteria to restrict eligibility should Trust Deeds and Protected Trust Deeds also be included? Has consideration been given to those who enter DAS or a Debt Management Plan?

Q5. Is there any other information that should be required for SEPA registration?

32. The information suggested seems reasonable but we would suggest that an address is also included on the publicly available register. This is a practical requirement as it can be envisaged that there will be multiple registrants with the same name or trading style and to the general public the only differentiating information that will be available will be an address.
33. One would not expect that the registration for SEPA status should be more involved than that required for a member of a LLP, for example.

Q6. Are there any other formalities and procedures that would have to be considered?

34. The administrative balance seems reasonable: there does not appear to be good reason for any other formalities and procedures. The concept of an individual having only one SEPA number ties in with the position regarding VAT registration. If an individual registers for VAT, it covers all of their business interests. If the individual wishes to allow a lender to take a charge over property, then this should be outwith the SEPA status. The individual will have to take a view as to whether to put the home at risk; but this would be an informed decision, rather than an unanticipated consequence of a business venture.

Q7. Are there any other negative impacts that we need to consider?

35. Some businesses which provide trade credit want to know whether an individual owns his own house but this is not the norm, and such businesses take a view regarding a certain amount of risk. They will also have credit limits in place.
36. The consultation paper says that SEPA status is for individuals and SEPA status cannot be shared jointly with others. How will SEPA interact with partnerships in the rest of the UK, which are not distinct separate legal entities as they are in Scotland?
37. Outside Scotland, partnerships are essentially a number of separate individuals in business each with joint and several liability. If some apply for SEPA status, and some don't, this would seem to bring unnecessary complications.
38. It would also will bring a lack of parity across legal jurisdictions where partners in, for example, an English or Welsh partnership can be protected but not in Scotland.

Q8. What is your evaluation of the SEPA concept? Will it be a useful addition to the UK business landscape and encourage enterprise?

39. A variety of opinions were expressed. For some it seems like a potentially useful addition; a little like a 'sole trader LLP'. The tax position would appear straightforward and simpler than an equivalent small private company.
40. From an insolvency perspective, though the principal objective is sound, the result appears overcomplicated and fraught with practical difficulties. Could not the same objective be achieved much more simply through other means, such as a level of 'protected equity' which would apply in all bankruptcies (see Q3 above)?

Lookthrough taxation for small companies

Overview

41. In overview, a compulsory system of lookthrough company taxation would, in the main, be unwelcome: it would be analogous to a return to deemed distributions and close company apportionment rules. It is thought appropriate, particularly for entrepreneurial companies, to be able to retain profits within the company, without these being charged to income tax on the business owners.

Deemed UK domiciled changes

42. One exception to this general view on lookthrough taxation is that it could offer welcome simplification for individuals affected by the new deemed domicile rules, who have overseas businesses.
43. In particular there could potentially be significant simplification for individuals who have interests in Limited Liability Companies (LLC) in the US, and who will be required to file a UK income tax self-assessment return. An individual may have shares in a significant number of such entities, which would be taxed on a combined lookthrough basis in the US.
44. Under current UK rules, each LLC would be treated as a separate business and the availability of double tax relief for underlying US tax paid is complex, both in terms of timing and analysis.

Simplification of corporation tax

45. With some reservations, such as loan relationship rules, corporation tax is in practice more straightforward in operation (and hence in less need of simplification) than, for example, income tax. To start by simplifying corporation tax is therefore perhaps not ideal.
46. Lookthrough taxation could bring simplification if it were to reduce the need for separate returns for payroll taxes, directors' income tax self-assessment, corporation tax and companies house returns; yet how easily this could be achieved is open to question. Many business owners chose a corporate structure, along with the potential tax complexity, in order to offer the flexibility.
47. Leaving profits within the company, and subject to corporation tax, while paying income tax and National Insurance when the profits are drawn, is seen as an advantage worth paying for.

Confusion of status

48. Small companies often fail to distinguish between the separate legal entity of the company and the owner/directors. Lookthrough taxation is perhaps only likely to increase that perception.
49. A lack of clarity between what belongs to the individual and what belongs to the company could also result in increasing numbers of overdrawn director loan accounts (non-compliance with Companies Act 2006) and result in increased risks and losses to creditors where a company subsequently fails.

Numbered questions are those set out in the Lookthrough discussion document at <https://www.gov.uk/government/consultations/lookthrough-discussion-document>

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

52. The five key issues in the discussion papers:
1. Who would lookthrough apply to (or be available for); is it possible to define easily the affected taxpayers?

2. How would it apply: how would profits be allocated to proprietors?
3. What tax consequences ensue: how would the tax be collected?
4. Would this be an optional, default or compulsory system?
5. Overall, would this deliver simplification?

52. The scope of the key questions is reasonable.

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?

53. The OTS report highlights the number of very small companies still in the system. There are potentially a number of reasons for this: including low corporation tax rates. It is possible that the most appropriate 'simplification' for such businesses would be to disincorporate.
54. Incorporation comes at the price of additional administration. If, as a matter of policy, it is thought best to reduce the number of small companies, there are a number of ways which might have impact here, including limitations of the minimum size of business which could be incorporated with limited liability and the availability of alternative business structures such as Sole Enterprise with Protected Assets.

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

55. It seems unlikely that growth companies would view lookthrough taxation as a benefit.

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?

56. It is arguable, that so long as the system is optional, there is no need for a turnover limit or other restrictions: if the business owners chose to be taxed directly on company profits, the impact would be on them alone.
57. Turnover is not the best indicator of eligibility. For example there can be companies with very large turnovers but with low margins, such as petrol retailers while other companies with more modest turnovers can have very large gross profit percentages, such as restaurants.

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

58. It would seem simpler to leave the existing salaries alone and to allocate the remaining profits among the owners. It could be argued that this might be manipulated where a company with several owners wished to allocate profits in a certain way. This is currently a risk through the approach of differential salaries and shareholdings.
59. Differentiation between trading and investment companies would make the system more complex.

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

60. The issues noted seem reasonable. Taxation of dividends is another issue. Generally, a company does not suffer tax on the company dividends received whereas individuals do. So lookthrough taxation could look like close company apportionment by the back door. Should consideration be given to a revived imputation system for dividends?

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

61. There are some remaining differences between income and corporation tax. The proposal is a reasonable way to take account of the difficulties. Apart from SSE and R&D tax credits, there are other reliefs available to companies or have been, such as land remediation relief and indexation of capital gains.

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

62. The approach suggested seems reasonable.

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?

63. A compulsory system would have drawbacks as outlined above. Yet the discussion paper correctly surmises that, by being optional, further work, and therefore further complexity would result. This may suggest that an alternative solution to the issue of small companies is needed (see question 2 above).

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

64. Having differing requirements for company law and taxation is an obvious complication. Cash accounting is not suitable for many businesses: those with significant levels of stock, work in progress, debtors and creditors.
65. Company accounts have a number of different users and though cash accounting might be acceptable for tax purposes, it is not an adequate basis for assessing profitability, supporting loan applications or making business decisions for most businesses.

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

66. There are significant non-tax reasons which limit the benefits of cash accounting. If companies were faced with submission of corporation tax returns in addition to lookthrough taxation, this would further reduce the benefit.

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

67. Overall, lookthrough taxation does not appear to offer significant simplification.