LOOKTHROUGH TAXATION

ICAEW welcomes the opportunity to comment on the discussion paper *lookthrough taxation* published by the Office of Tax Simplification on 8 July 2016.

This response of 15 September 2016 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

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MAJOR POINTS

Key point summary

1. ICAEW welcomes the opportunity to discuss the lookthrough taxation model which removes the corporation tax liability and taxes the owners on their share of the company's income and gains.

2. ICAEW supports the intention to simplify the taxation of small companies.

3. However we do not believe that the potential benefits of lookthrough are sufficient to support the introduction of the a new model at this time. Currently there are two complicated systems, one for unincorporated business and one for corporate bodies. Rather than introduce a new model we would support simplification in each area.

4. We are concerned that there is already a significant amount of confusion among small business owners who have incorporated their business but are unaware of their legal obligations. Introducing a lookthrough model which has characteristics of a company but also those of an unincorporated body will lead to further uncertainty and confusion and will increase the potential for errors. For example, under lookthrough the company will still need to file accounts as the company is regarded a corporate entity for all purposes other than tax, however the need to file a corporation tax return may be removed. The individuals will be required to pay income tax and national insurance but on a tax adjusted profit figure which has perhaps been calculated using the corporate regime.

5. If a lookthrough model were adopted we believe it would need to be very clear which rules apply as the issue of employment versus self-employment becomes problematic. The treatment of expenses would need to be explicitly clear and either the rules for unincorporated businesses or companies should be adopted. Introducing a mixture of rules will only add further confusion.

6. Clarification is required regarding the rates of income tax that would be payable on the company's profits, and whether such income would be treated as non-savings income or dividend income.

7. If there is an appetite for lookthrough it could be sensible to promote an existing alternative structure such as a limited liability partnership, although this would introduce the issue of all proprietors being jointly and severally liable.

8. On the surface lookthrough could be straightforward in achieving simplification but there appear to be many unanswered questions which we raise in this response. In creating a hybrid between two existing business structures there is risk of creating more confusion for the simplest of businesses that wish to operate in a straightforward manner.

9. We believe that the introduction of Making Tax Digital (MTD) will have a significant impact on many smaller businesses and are concerned that too much choice and change in a relatively short period is not sensible. If the lookthrough model is further developed we believe any MTD implications should be considered in tandem.

10. ICAEW is aware of and has responded to the OTS discussion paper on Sole Enterprise Protected Assets (SEPA) in ICAEW rep 135/16. Our concern is that lookthrough and SEPA both offer new statuses somewhere between that of a sole trader and a company, but result in very different outcomes. To the unrepresented and the smallest of businesses, too much choice can lead to complexity and costs rather than simplification.

RESPONSES TO SPECIFIC QUESTIONS

KEY ISSUES

Q1: Do you agree with the five key issues noted? If not how would you change or add to them?

11. We agree with the key issues identified in the paper but would also add “how are the profits of the business calculated for tax purposes?” as this is a fundamental component of the lookthrough model. It follows that consideration would then need to be given to whether tax is payable for a chargeable accounting period under the corporate regime or whether the basis period rules are adopted.

12. We note that as part of Making Tax Digital (MTD) there is current consultation on replacing the basis period rules (perhaps with chargeable accounting periods) for unincorporated businesses. To avoid uncertainty we recommend that a consistent approach is adopted.

WHO WOULD LOOKTHROUGH APPLY TO?

Q2: 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?

13. In theory we agree that the companies who could benefit from lookthrough would not intend to increase in size and distribute all or almost all of their profits.

14. In practice complexities will arise where a business decides to retain their profits for future growth/investment opportunities. It will become necessary to reconcile the profits taxed compared to the profits extracted.

15. As highlighted in the OTS paper, companies who decide to retain some funds for investment will be disadvantaged as only post-tax profits will be available.

16. Many small business owners are already faced with difficult decisions when starting up a business and having to look into the future and decide if the business will grow or not may not be feasible on a practical level. Our main concern here is what would happen once a non-growth company decides it wants to grow? Would it be able to easily transition out of the lookthrough model, and what costs would be involved?

17. We believe that careful thought must be given to personal service companies in respect of lookthrough taxation. If personal service companies are not eligible for lookthrough (which we believe to be the case) there will need to be a process in place for determining whether a company falls within the IR35 rules, which in itself will be a complex task. We question if there is any merit in considering if and how lookthrough could apply to personal service companies.

Q3: Do you think lookthrough would have an impact on growth companies if applied to them? If so, how?

18. Please see our comments above.

Q4: Leaving aside your views on whether lookthrough is a good idea 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?

19. The introduction of a threshold can encourage distortionary behaviour, encouraging businesses to operate just below the threshold.

20. Consideration would need to be given as to how the limit would apply if the company operated in a group structure or if there were husband and wife companies.

21. If a limit were to apply it would be sensible to set it in line with an existing limit such as the cash accounting limit/VAT threshold.

HOW WOULD IT APPLY?

Q5: If allocation is made, should salaries be added back or left to stand?

22. Allocating profits to proprietors after salaries paid could encourage more salaries to be paid between the lower earnings limit and the primary threshold. This could be seen as a planning opportunity which detracts from the idea of lookthrough, which is to obviate the need for planning on how to extract funds from the company.

23. If salaries are left to stand, consideration would need to be given to whether class 1 secondary national insurance paid would be an allowable expense of the business.

24. Adding back salaries would be a simple adjustment in common with disallowing depreciation, for example, and therefore seems sensible. It would however also introduce the requirement for a credit to be issued for any income tax/national insurance suffered which could be seen as adding further complexity.

Q6: Are there other significant “other issues” that need to be considered beyond the five noted above?

25. The five issues noted in the discussion paper are fundamental to the operation of the lookthrough model. The identification of these issues evidences the complexities involved in designing and adopting this model to ensure as much benefit is derived as possible.

26. Serious consideration must be given to the regime for expenses. If the overarching aim of lookthrough is to treat the company as see-through then it may be appropriate to adopt the rules for the unincorporated trader. This would mean the benefit in kind rules would not apply and instead adjusting for any private use of assets.

27. This would mean that benefits of the corporate regime (such as amortisation, SSE, R&D relief) would not be available which would be a disadvantage to certain businesses.

28. The paper does not consider the interaction between the lookthrough model and double tax relief. For example, if the company has overseas property income, which has been subject to foreign tax, would UK income tax be available for offset? Not only is income tax being paid instead of corporation tax but the tax is borne by a different person (the shareholder and not the company).

29. We assume the individual shareholders would be legally liable to pay the tax and therefore the accounts will not include a tax expense or tax payable figure. We would like to clarify the position if the individual were unable to meet their liability and whether the company would be ultimately liable or act as a guarantor in some capacity.

WHAT TAX CONSEQUENCES WOULD ENSUE? HOW WOULD IT BE IMPLEMENTED?

Q7: What other types of income do we need to consider for lookthrough?

30. We believe that consideration would need to be given to company pension contributions and charitable donations. If the company is being ignored, would these become personal pension contributions and gift aid donations?

Q8: Do you agree with the outline treatments above or do you have any suggestions on how they should be treated differently?

31. The paper does not address whether the individuals would pay income tax for the company's chargeable accounting period or whether basis period rules would be adopted.

32. If chargeable accounting periods are extended unincorporated businesses under the MTD rules then it be sensible to employ this method under lookthrough too.

33. Although the treatment of losses is discussed in the discussion paper there is no reference to how relief would be obtained for class 4 national insurance contributions.

34. The paper does not address the treatment of capital assets transferred from the company to the owner and we question whether this would be treated as a taxable benefit or in some other way.

35. We agree that it would be simpler to ignore VAT and to only apply the lookthrough rules to income and gains subject to corporation tax.

OPTIONAL OR COMPULSORY?

Q9: 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?

36. If lookthrough were to be introduced it should be optional, although that would require better off calculations which would increase costs to the taxpayer and would increase the scope for tax planning. We do not see any justification or principles that would support mandating lookthrough. Aside from the need to address a number of design problems (e.g. is the company a non-growth company?) and also how you would deal with existing companies, the change would add considerable extra admin burdens and costs both in the transition and potentially recurring thereafter.

OTHER ISSUES

Q10: Would cash accounting be a useful simplification for lookthrough companies?

37. In some ways it would be as it would align the proposals for MTD with that of lookthrough,. However, a lookthrough company is still legally a company under the Companies Acts and would therefore will need to prepare accounts on the accruals basis for Companies House. Unless corresponding changes were made to the Company Law rules, introducing the cash basis to companies is likely to increase the total administrative burden, aside from any transitional costs of moving to a new set of rules.

Q11: Would cash accounting be useful to companies even if they still had to produce a corporation tax return?

38. We are not convinced that it would be as accounts will need to be prepared on a cash basis for tax purposes and an accruals basis for accounts and reporting purposes, thus increasing the administrative burden. If lookthrough eliminates corporation tax why is a corporation tax computation needed?

39. Would the administration be similar to that of partnerships and would there be a need to reconcile the profits of the company to each individual?

WOULD THIS DELIVER SIMPLIFICATION?

Q12: Can lookthrough deliver simplification?

40. The discussion paper states that it is the adjustments to profits calculation that small businesses struggle with. This may be partly true, but the existing system is tried and tested and we would not recommend changing it for a system that does not appear to offer any clear advantages. The lookthrough model still requires profits to be adjusted, whether this is under the rules for companies, unincorporated traders or even the cash basis. Given that requirement we do not think that lookthrough provides a solution to the stated problem.

41. We do appreciate that this model could remove the need to consider personal tax planning i.e. salary versus dividend.

42. A more appropriate simplification would be to make it easier for companies to disincorporate. We understand that disincorporation relief was introduced for a five year period and believe it would be appropriate to extend the relief and increase awareness of its availability.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).