Consultation on a disincorporation relief

30 August 2012
Introduction

We are pleased to have this opportunity to respond to the HM Treasury ‘Consultation on a disincorporation relief’ published on 7 June 2012.

We welcome the Government’s initiative in proposing to take forward elements of the discussion paper entitled ‘Disincorporation of small companies’ published by the Office of Tax Simplification on 28 July 2011, to which we responded on 7 October 2011.

We support the introduction of a new tax relief to facilitate disincorporation. We believe that such a relief is needed to remove a distortion from the existing tax system – a distortion that currently makes it difficult for businesses to choose the legal structure most appropriate for their current and anticipated future circumstances. We see such a relief as being necessary to add a degree of simplification and balance to the tax system. To achieve this we believe that the relief should be a permanent feature of the tax system, and should not be time limited.

It is wrong in principle that the choice of business entity should have a tax consequence. So long as this is the case, there will be new business start-ups that adopt a structure that is not the most appropriate for them, and then realise their mistake later. In such circumstances it is only fair and reasonable that they should be allowed to re-visit that choice without penalty. This is currently a privilege reserved to those who have chosen an unincorporated structure, but unfairly denied to those who have incorporated.

From 1 April 2002 to 31 March 2006, the 0% starting rate of corporation tax persuaded many small businesses to incorporate. Assuming that the 0% rate would continue, they would have been foolish not to incorporate. However, the Government of the day then withdrew the 0% rate, accusing such businesses of taking unfair advantage of tax planning opportunities. In reality the businesses in question had been misled by the Government, and as a result many of them, even today, still face disproportionately high compliance costs. They should be helped to disincorporate where appropriate.

We are committed to supporting the Government in its commitment to simplify the UK tax system. A disincorporation relief, as a mirror image of the existing incorporation reliefs, would be an important step towards simplification. However, it would bring unnecessary complexity if, unlike the incorporation reliefs, it was restricted to the smallest businesses as arbitrarily defined by legislation. Instead, it should be generally available to all businesses. We believe this would not be abused, because limited liability will always be an imperative from almost all medium-sized and large businesses.

Our responses to HM Treasury’s consultation questions

Question 1: Do you agree with the criteria for assessing any new policy interventions to support disincorporation? Are there any other criteria you would suggest?

We understand the Government’s reasoning in putting forward the criteria listed in paragraph 2.1 of the consultation paper. We agree with these, with one important exception.

We agree that the relief should be targeted where it is most effective. However, the OTS finding that the decision to disincorporate appears most relevant for the smallest businesses has been taken out of context.

The OTS remit related specifically to small business tax, and included providing recommendations to the Chancellor on areas of complexity and uncertainty for small businesses. In that context the OTS noted at paragraph 2.16 of their discussion paper:

‘There was a huge rise in tax motivated incorporations for the smallest businesses following the introduction of the 10% “starting rate” of corporation tax in 2000 and, more significantly, its subsequent reduction to 0% in 2002.’

Within the context of small business tax, the OTS were heavily influenced by the exceptional circumstances created by the starting rate, and especially the 0% starting rate, where we
would respectfully suggest that the Government of the day had failed to anticipate the 
behavioural effects on small businesses when faced with a gift horse. This did indeed bring 
about an exceptionally high population of the smallest businesses, misled into incorporating 
between 2002 and 2006 and now wishing to disincorporate.

The OTS, on being asked to look only at small business tax, were bound to arrive at this 
conclusion. It is regrettable that they were not invited to address the much more important 
underlying issue – that it is wrong in principle that the choice of business entity should have a 
significant tax consequence.

Much of the complexity of the burdensome UK tax regime, and a great deal of the incentive 
for aggressive tax planning, arise from the fact that different business structures are taxed in 
different ways. For example, the rates of income tax and corporation tax differ widely, and 
National Insurance Contributions represent a tax on some types of income but not others.

Businesses of all sizes should be free to adopt the structure most suited to their 
circumstances. For example, if they need the simplicity and flexibility of a sole trade or a 
partnership on the one hand, or the protection of limited liability on the other, they should be 
encouraged to make the right choice without having artificial tax hurdles placed in their way. 
Furthermore, as they expand or contract, they should be free to modify their business 
structures to suit their changing circumstances.

In principle, all businesses should be free to disincorporate without tax penalty, just as they 
are currently able to incorporate without tax penalty. We believe this would not be abused, 
because limited liability will always be an imperative for almost all large businesses. However, there might be circumstances where (for example) an SME might wish to 
disincorporate, and we believe that it should not be prevented or discouraged from doing so 
by artificial hurdles presented by the tax system.

As suggested in your Tax Impact Assessment at paragraph 5.1, we believe that truly tax-
neutral reliefs for both incorporation and disincorporation might support growth by levelling the 
playing field between different legal forms and driving lower costs throughout the SME sector.

**Question 2:** What is your assessment of the above reasons for disincorporation? How 
important is reduced administration compared to the other advantages and disadvantages of 
different legal forms such as tax and limited liability?

As explained above, we see the reasons for a new disincorporation relief going much wider 
than those outlined in your consultation document. While there are undoubtedly a significant 
number of very small businesses that incorporated to enjoy the 0% starting rate of corporation 
tax and now wish to disincorporate, we see a broader justification for the new relief as a 
means of removing artificial distortions from the tax system.

Limited liability, reduced administration and the separation of a company’s financial affairs 
from those of its proprietors are all factors which can be taken into account. Our basic 
premise is that the Government has it within its power to create a more level playing field for 
companies and unincorporated businesses by allowing tax-neutral disincorporation to match 
the already comprehensive provisions facilitating incorporation. In the interests of 
simplification and fairness, there are good reasons to do this.

**Question 3:** For agents and representative bodies – what is your overall impression of the 
number of companies who, after consideration of these various factors, might wish to 
disincorporate? How does this vary for businesses of different size or turnover?

As stated above, we believe that the 0% starting rate encouraged many small businesses, 
quite inappropriately, to establish themselves as companies. We think that many of these 
now wish to disincorporate. We anticipate that there would be fewer medium-sized or large 
companies wishing to disincorporate, but offering them tax reliefs to facilitate this would 
remove an unwelcome distortion that currently exists within the tax system.
**Question 4:** In practice, for the smallest businesses most likely to want to disincorporate: What level of assets are these companies likely to hold? And which tax charges on the company and shareholders are most likely to be significant? If possible please provide examples.

By definition, the smallest businesses likely to wish to disincorporate are probably holding relatively modest levels of assets. Many will own plant and machinery, stock in trade and work in progress. Some will own goodwill, and most of them are unlikely to have any clear idea of the value of their goodwill.

**Question 5:** In practice, how significant an issue is the requirement to hold sufficient reserves in the company to fulfil the obligations of the Companies Act likely to be when a business disincorporates? How does this compare to the other issues listed above?

We assume that in most cases a company would have to be put into liquidation as part of the disincorporation process, so that the interests of creditors would be protected. It would make sense to allow this to be short-circuited in the case of small companies with straightforward financial affairs, and we think that the existing provisions for striking off without a formal liquidation would be an adequate safeguard for creditors in such cases. However, the existing rules for striking off would not seem to be a practical route for any company that wishes to disincorporate without interruption to the activities of the business that is carried on initially by the company and then in unincorporated form, and Company Law changes might need to be made to remedy this.

**Question 6:** How much do respondents estimate the legal/accountancy charges of disincorporation would be?

The legal and accountancy charges of disincorporation would vary widely according to the circumstances of each case, and would be dependent upon whether or not a formal liquidation was involved. It is not feasible to generalise on this.

**Question 7:** Overall, which are the most significant barriers to disincorporation and how important is tax in relative terms? Are there other significant barriers or administrative issues not included? If possible, please provide specific examples of time and costs involved.

We see tax as the principal barrier to disincorporation. Another crucial barrier for very small companies is the administrative cost of disincorporation, especially where it would involve liquidation.

**Question 8:** How effectively would a tax relief help address overall barriers to disincorporation? How well would it meet the criteria we have set out in Chapter 2?

A new disincorporation relief would meet a perceived commercial need. Depending upon the size of businesses to which it was available, it should be targeted towards some or all of the businesses where it would be most effective. It should be relatively simple to understand and practicable to administer, but might fall short on both these counts if it was restricted to only very small companies and if it was time limited – since in those circumstances some of the businesses most in need of the relief might be marginally too large or too late to take advantage of it.

**Question 9:** If the Government were to introduce a disincorporation relief, which charges should it cover? How important is the element of the relief for shareholders, and what is your view on the additional rules that might be needed to make this element of this relief work and prevent abuse?

In the interests of fairness, the new disincorporation relief should remove the corporation tax charges on the company in respect of the chargeable gain on goodwill, and in respect of plant and machinery and land. To relieve these selectively – for example, relieving the charge on
goodwill but not those on plant and machinery or land – would unfairly favour some types of business and mitigate against others. That would be inequitable.

The potential charges on shareholders are closely bound up with those on the company, and the nature of such charges depends upon the way the disincorporation is approached. The produce a level playing field that would allow all companies to disincorporate, there should also be relief from charges on shareholders arising from a disincorporation – mirroring the pre-existing reliefs available on an incorporation.

**Question 10:** Reflecting the above and the criteria in Chapter 2: do you have any other comments on how the Government could design a relief, including the size of business eligible or its lifespan?

We believe that the new disincorporation relief should apply to companies of all sizes, as a mirror image of the pre-existing relief for incorporation. It should be a permanent feature of the tax system and should not be time limited. The OTS recommendation of a limited life span of five years appears to have been based on an examination of the needs of the very smallest companies, many of which had been persuaded to incorporate to take advantage of the starting rate of corporation tax. Since we see the need for a disincorporation relief that would serve a wider range of companies, we see no reason to time limit the relief.

If the Government is not persuaded that the new relief should be made available to companies of all sizes, then we suggest that it should be available at least to all SMEs.

**Question 11:** What are your overall views on the likely take up of a disincorporation relief? How high priority would you place on this reform in comparison to other changes being made or considered for the tax system?

It would take time for the smallest businesses to take advantage of a new disincorporation relief, partly because some of those that misguided incorporated to take advantage of the 0% starting rate are likely to be unrepresented by tax agents or advisers. This supports our belief that the new relief should not be time limited, otherwise some small businesses that could benefit from it might miss the window of opportunity.

We have long supported attempts by successive Governments to simplify the tax system. At times it is tempting to look at this in terms of trying to reduce the volume of tax legislation, but it is just as important to concentrate on simplifying the tax system at the ‘point of delivery’ to businesses and individuals. It is hard to see how ordinary taxpayers could expect there to be legislation facilitating incorporation but none to facilitate disincorporation. It is wrong that some businesses but not others should find themselves locked into a legal structure that they find unsuitable, for whatever reason. Introducing the new disincorporation relief would be an important step in bringing greater balance to the tax system.

**Question 12:** How effective could improved guidance be in reducing overall barriers to disincorporation?

We agree that it would be helpful if comprehensive, consolidated guidance was available in one place, covering all the practical issues needing to be addressed in order to disincorporate – together with a clear explanation of all the steps that would need to be taken.

**Question 13:** What changes would you suggest to simplify the process of disincorporating without reducing creditor protection? How would these meet the criteria set out in Chapter 2?

Please see our answer to Question 5 above.
**Question 14:** Can you provide more information about the possible impact of a disincorporation relief against these categories, in particular, the overall impact on small business and administrative burdens?

The tax regime imposes administrative burdens on businesses wherever it places artificial barriers in the way of allowing them to adopt the legal structure best suited to their circumstances. Any new relief to make disincorporation easier and less costly should be an important step towards making the tax system more user-friendly towards companies eligible for that relief, and their shareholders. This should benefit the economy by removing existing barriers that impose unnecessary compliance and other administrative costs on businesses.

**Conclusion**

We support the introduction of a new tax relief to facilitate disincorporation, and see this as a necessary simplification to the existing over-complex tax regime. It is wrong in principle that the choice of business entity should have significant tax consequences. A disincorporation relief, as a mirror image of the existing incorporation reliefs, would be an important step towards simplification. However, it would bring unnecessary complexity if, unlike the incorporation reliefs, it was restricted to the smallest businesses as arbitrarily defined by legislation, or if it was time limited. Instead, it should be generally available to all businesses as a permanent feature of the tax regime. We believe that extending the relief to more than the smallest companies would not be abused, because limited liability will always be an imperative from almost all large businesses.

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