THE FALL OF PARTNERSHIPS: A COMMERCIAL DECISION OR A TAX DECISION?

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ABSTRACT - THE FALL OF PARTNERSHIPS: A COMMERCIAL DECISION OR A TAX DECISION?

The fundamental question addressed in this thesis is: can the fall of the ordinary partnership be attributed to commercial (non-tax) considerations, or is it, at least in part, due to the distortionary effects of the tax system? The author seeks to establish, primarily using new empirical research, that the tax system is highly likely to have had a significant role to play in the demise of partnerships. That is not to say that genuine commercial considerations are irrelevant but, given that basic principles of good tax design require that taxation should not affect business form selection, the present situation must be regarded as unsatisfactory. The need for systemic reform, or at the very least steps towards it, is clear.

Chapter 1 presents the statistical background to the thesis. Chapter 2 considers the economic viability of the partnership as an alternative to incorporation for businesses involving more than one owner-manager, highlighting the limited liability illusion. Chapter 3 addresses the failing of the LLP, notwithstanding some initial optimism that the form would be highly attractive to businesses of all sizes. Chapter 4 explores the unfortunate truth that numerous acts of incorporation are, and have been, driven by tax considerations, rather than the sound commercial reasons discussed in Chapter 2. The availability of a double tax saving – perhaps exaggerated by artificial income splitting – in the corporate form for would-be partners leaves the partnership as the most vulnerable form for tax-motivated incorporation. Chapter 5 presents the case for a disincorporation relief as a way out for owner-managers locked into the company structure and concludes the thesis. Annexes A-D provide supplementary information, whilst Annex E provides a postscript on a more controversial proposal involving the decoupling business form and tax treatment.

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Writing this section has been as challenging as parts of the thesis itself. In the words of Dr Seuss, I have had to '*think and wonder, wonder and think' (Oh, the Places You'll Go!).* A list of names seems like a rather dull addition, but to elaborate risks boring the reader who has already been brave enough to tackle the material that follows – or at least consider doing so. That being the case, I shall say just two things…

Following in the footsteps of DPhil acknowledgement tradition, I thank all the brilliant people who supported me throughout this process, and never lost faith.

To the 361 strangers that kindly gave me their time in the midst of a global pandemic, this thesis is dedicated to you. It must be, for it would not have been possible without you. If you happen to be one of those people, and you are reading this, I thank you once more, and hope that if you continue reading, you find the content interesting.

LIST OF ABBREVIATIONS

Arctic Systems Case	*Jones v Garnett* [2007] UKHL 35
BADR	Business Asset Disposal Relief
BPR	Business Property Relief
CA 2006	Companies Act 2006
CA 1985	Companies Act 1985
CGT	Capital Gains Tax
CIOT	Chartered Institute of Taxation
COVID-19	Infectious disease caused by the SARS-CoV-2 virus
CTA 2009	Corporation Tax Act 2009
CTA 2010	Corporation Tax Act 2010
DBEIS	Department for Business, Energy & Industrial Strategy
DBIS	Department for Business, Innovation and Skills
DTI	Department of Trade and Industry
ERA 1996	Employment Rights Act 1996
EURL	*Enterprise Unipersonelle à Responsibilité Limité*
FA 2002	Finance Act 2002
FA 2004	Finance Act 2004
FA 2013	Finance Act 2013
FAME	Financial Analysis Made Easy
GAAP	Generally Accepted Accounting Practice
HM	Her Majesty's
HMRC	Her Majesty's Revenue & Customs
IHTA 1984	Inheritance Tax Act 1984

IR35	Income Tax (Earnings and Pensions) Act 2003, Part 2, Chapter 8
ITA 2007	Income Tax Act 2007
ITEPA 2003	Income Tax (Earnings and Pensions) Act 2003
ITTOIA 2005	Income Tax (Trading and Other Income) Act 2005
JISC	Joint Information Systems Committee
LFS	Labour Force Survey
LLP Act 2000	Limited Liability Partnerships Act 2000
LPA 1907	Limited Partnerships Act 1907
LTC	Look Through Company
NI	National Insurance
NICs	National Insurance Contributions
NLW	National Living Wage
NMW	National Minimum Wage
OBR	Office for Budget Responsibility
ONS	Office of National Statistics
OTS	Office of Tax Simplification
PA 1890	Partnership Act 1890
PAYE	Pay As You Earn
PET	Potentially Exempt Transfer
PPP	Personal Pension Plan
R&D	Research and Development
SDLT	Stamp Duty Land Tax
SEPA	Sole Enterprise Protected Asset
SIPP	Self-investment Personal Pension Plan
SSCBA 1992	Social Security Contributions and Benefits Act 1992

SSCR 2001	Social Security (Contributions) Regulations 2001 SI 2001/1004
TMA 1970	Taxes Management Act 1970
VAT	Value Added Tax
VATA 1994	Value Added Tax Act 1994

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CHAPTER 1: THE OWNER-MANAGED BUSINESS COMMUNITY

1.1 STATISTICAL INTRODUCTION

The growth in the business population - persons in work that are not employees - in recent years is well documented.[1] Writing in 2017, Adam, Miller and Pope made the following observation:

> …recent trends have led to a marked increase in individuals working for their own business. The share of the workforce working for their own business (14.7%) is at its highest level since at least 1994 (when it was 13.7%) and has increased from a low point of 11.8% in 2000-2001…39% of the cumulative increase in the workforce…has resulted from an increase in the number of individuals working for their own business.[2]

Between 2000 and 2020[3] the number of private sector businesses in the UK grew by 2.5 million (+72%). Since 2007, the UK has had a faster growing private sector business

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1 Some of the recent increase is attributable to the rise of the 'gig economy'. The term 'gig economy' is not a well-defined concept, but 'it tends to be used to refer to individuals who are operating as an independent small business…rather than through an employment contract and using a digital platform operated by a large company to match them to customers.…': Stuart Adam, Helen Miller and Thomas Pope, *Tax, Legal Form and the Gig Economy*, Institute for Fiscal Studies, 2017, 2. This matter is explored in further detail in: Matthew Taylor and others, *Good Work: The Taylor Review of Modern Working Practices*, 2017 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/627671/good-work-taylor-review-modern-working-practices-rg.pdf> accessed 3 April 2022.

2 Adam, Miller and Pope (n 1) 5.

3 The headline statistics are based upon the figures for the start of each year. Unless otherwise indicated, figures are extracted from: Department for Business, Energy and Industrial Strategy, *Business Population Estimates for the UK and Regions 2020 Statistical Release*, 8 October 2020 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/923565/2020_Business_Population_Estimates_for_the_UK_and_regions_Statistical_Release.pdf> and accompanying detailed tables <https://www.gov.uk/government/statistics/business-population-estimates-2020> accessed 1 April 2022.

The author has omitted statistics from 2021 due to the adverse effects of the COVID-19 pandemic. The figures are unlikely to be an accurate representation of overall business trends and demonstrate a 6.5% reduction in the number of private sector businesses (-389,600), though the number of companies once again rose (+21,000). See: Department for Business, Energy and Industrial Strategy, *Business Population Estimates for the UK and Regions 2021 Statistical Release*, 7 October 2021 <https://www.gov.uk/government/statistics/business-population-estimates-2021> accessed 3 January 2022.

population than any other OECD country.[4] The majority of the increase (88%) is attributable to a growth in the number of owner-managed (non-employing) businesses.[5] The 2020 Department for Business, Energy & Industrial Strategy ("**DBEIS**")[6] estimates indicate that at the start of 2020 there was a record number of 6 million private sector businesses; an increase of 1.9% on the previous year (+113,000 businesses)[7] of which 99.3% were classed as small

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4 Jonathan Cribb, Helen Miller and Thomas Pope, *Who Are Business Owners and What Are They Doing?*, Institute for Fiscal Studies, June 2019, 5.

Stuart Adam and Helen Miller, *Taxing Work and Investment Across Legal Forms: Pathways to Well-Designed Taxes*, Institute for Fiscal Studies, January 2021, 23: 'The growth in business owner-management in the UK has been remarkable by international standards. Since 2000, the majority of other OECD countries have experienced little change or a reduction in the share of self-employed [including partnerships] people hiring no employees. As of 2019, the UK has the second-highest number of self-employed people with no employees (as a percentage of the total workforce), with only Italy higher (at 15%).'

5 Adam and Miller (n 4) 6.

By way of comparison the Department of Business, Innovation and Skills estimates released in October 2015 documented the 2000-2015 period as having seen an increase of 55% in the overall business population: owner-managed businesses accounted for 73% of the overall increase. The highest rates of increase (+7%) were between 2003 and 2004, and between 2013 and 2014: 2020 Business Population Estimates (n 3) 6; Department for Business, Innovation and Skills, *Business Population Estimates for the UK and Region 2015* <https://www.gov.uk/government/statistics/business-population-estimates-2015> accessed 1 April 2022. Whilst the DBEIS figures only report data from the year 2000 onwards, Claire Crawford and Judith Freedman, 'Small Business Taxation', in Stuart Adam and others (eds), *Dimensions of Tax Design: The Mirrlees Review* (OUP 2010)1037-1038, similarly observe that: 'The number of businesses with no employees increased from just over 2.5 million (68%) in 1996, to over 3 million (73%) in 2006. By contrast, the number of businesses with at least one employee did not rise at all between 1996 and 2006, falling as a percentage of the total from 32% in 1996 to 27% in 2006…[t]hus a disproportionate amount of the increase in the number of businesses in recent years has been of businesses with no employees.'

6 Formerly the Department for Business, Innovation and Skills (disbanded on 14 July 2016).

7 Business Population Estimates 2020 (n 3) 1. Additional business population estimates reviewed by the author include: Department for Business, Innovation and Skills, *Business Population Estimates for the UK and Regions 2011*, 12 October 2011: <https://www.gov.uk/government/statistics/business-population-estimates-for-uk-and-regions-2011> accessed 3 April 2022; Department for Business, Innovation and Skills, *Business Population Estimates for the UK and Regions 2012*, 17 October 2012: <https://www.gov.uk/government/statistics/business-population-estimates-for-the-uk-and-regions-2012> accessed 3 April 2022; Department for Business, Innovation and Skills, *Business Population Estimates for the UK and Regions 2013*, 23 October 2013 < https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/254552/13-92-business-population-estimates-2013-stats-release-4.pdf> accessed 3 April 2022; Department for Business, Innovation and Skills, *Business Population Estimates for the UK and Regions 2014*, 26 November 2014 <https://www.gov.uk/government/statistics/business-population-estimates-2014> accessed 3 April 2022; Department for Business, Energy and Industrial Strategy, *Business Population Estimates for the UK and Regions 2016*, 13 October 2016 <https://www.gov.uk/government/statistics/business-population-estimates-2016> accessed 3 April 2022; Department for Business, Energy and Industrial Strategy, *Business Population Estimates for the UK and Regions 2017*, 30 November 2017 <https://www.gov.uk/government/statistics/business-

businesses.[8] 4.5 million (76%) of those businesses had no employees and are therefore regarded as owner-managed.[9] 2020 marked the second year of increase in the number of private sector businesses since the first decrease in the private sector business population (-0.5%) observed in 2017-2018.[10] The overall average growth rate in the 2000-2020 period was 3% per annum.

population-estimates-2017> accessed 3 April 2022; Department for Business, Energy and Industrial Strategy, *Business Population Estimates for the UK and Regions 2018*, 11 October 2018 <https://www.gov.uk/government/statistics/business-population-estimates-2018> accessed 3 April 2022; Department for Business, Energy and Industrial Strategy, *Business Population Estimates for the UK and Regions 2019*, 10 October 2019 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852919/Business_Population_Estimates_for_the_UK_and_regions_-_2019_Statistical_Release.pdf> accessed 3 April 2022.

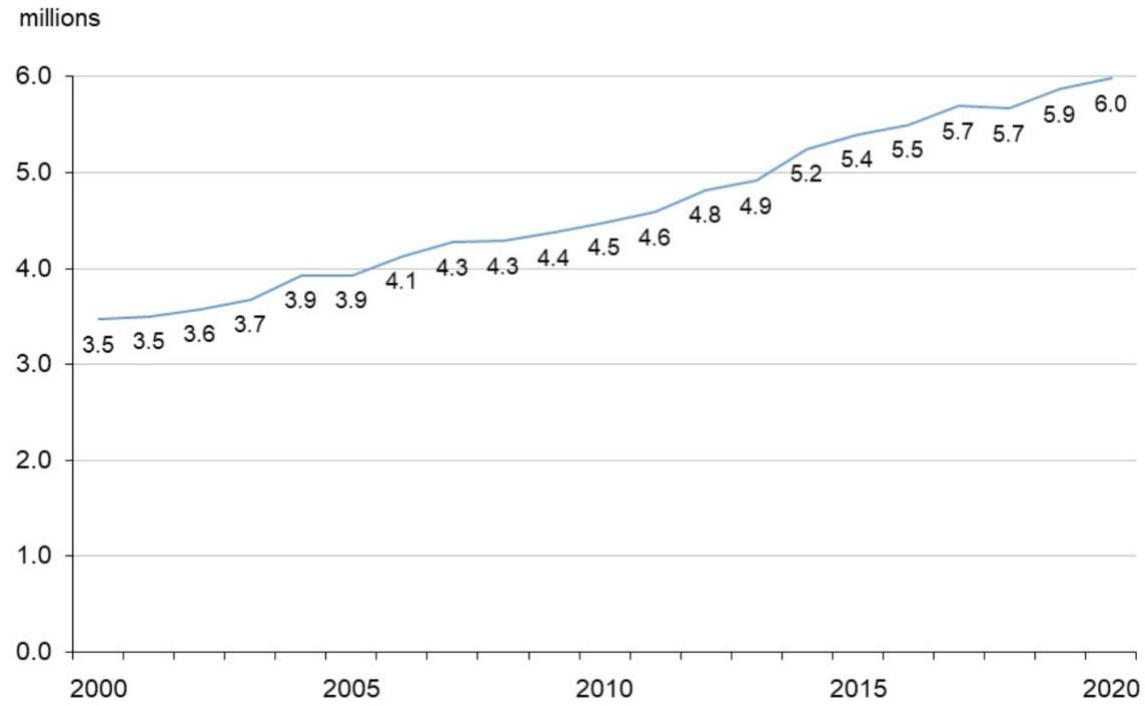
8 Department for Business, Energy and Industrial Strategy, *Business Population Estimates for the UK and Regions 2020, Methodology & Quality Note*: 'In the Statistical Release, we refer to small as those with 0 to 49 employees, medium as 50 to 249 employees and large as 250 or more employees. We also use the term "SME" to cover all businesses with 0 to 249 employees', 5 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/921366/METHODOLOGY_QUALITY_NOTE_2020.pdf> accessed 3 April 2022.

9 Business Population Estimates 2020 (n 3) 1.

Adam, Miller and Pope (n 1) 11: 'The business owner-manager population has always encompassed a large variety of business models that span the entire income distribution. People using a business legal form (rather than being employees of another company, for example) include everyone from taxi drivers, plumbers and local shop owners, to IT consultants, doctors and lawyers, to those running genuinely innovative businesses that will go on to grow and employ others. However, to the extent that it is possible to describe the stereotypical closely held business, it is one that is likely to survive for less than five years, that creates an income much below the average for employees and that neither invests nor employs others.'

10 Based upon the available DBEIS figures which started reporting in 2010. In this year, the number of non-employing businesses fell by 1% (-50,000). The private sector business population fell by 0.5% (-27,000): Business Population Estimates 2018 (n 7) 1.

Figure 1: Number of Private Sector Businesses in the UK 2000 to 2020[11]



Writing in 2015, Morse observed that: '[b]y the turn of the century…the demise of the [ordinary] partnership as the universal form for small businesses was well under way.'[12] Indeed, notwithstanding the sustained increase in business population, there is an overall downwards trend in the number of ordinary partnerships in recent years.[13] Given the lack of registration requirement for partnerships it is not possible to obtain completely accurate

11 Business Population Estimates 2020 (n 3) 1.

12 Geoffrey Morse, *Partnership and LLP Law* (8th edn, OUP 2015) 27. At this point in time, the BIS reported that partnerships comprised 9% of the business population: Business Population Estimates 2014 (n 7). In 2014, the Office of Tax Simplification reported that 55% of partnerships has a turnover of £75,000 or less, see: Office of Tax Simplification, *Small Business Taxation Review, Interim Report*, March 2011, 3 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/199183/05_ots_small_business_interim_report.pdf> accessed 3 April 2022.

This point was reiterated in a later edition of the book: Geoffrey Morse and Thomas Braithwaite, *Partnership and LLP Law* (9th edn, OUP 2020) 29.

13 Minor increases in the number of ordinary partnerships have been observed in the years 2011, 2012, and 2014, but are not sufficient to reverse the overall trend. For further detail see Business Population Estimates 2020 Detailed Tables (n 3).

figures.[14] The 2020 DBEIS figures report that ordinary partnerships comprised just 7% of the overall business population which, even though this is same as the reported 2019 and 2018 figures, is an overall decrease of 1.2% over the 2015-2020 period.[15] The total number of ordinary partnerships in the 2015-2020 time frame has also decreased by 5.1% (-22,420).[16] By way of contrast, owner-managed companies have been the fastest growing legal form.[17] They accounted for 34% of the private sector business population at the start of 2020 (again the same as 2019 and 2018), which is a 4% increase in the share of the private sector business population since 2015, and a 24.5% increase in the overall number of companies between 2015-2020.[18] Whilst sole traders still account for the majority of the business population (59%), and the 2015-2020 figures reflect an increase of 6.5% in terms of the overall number of sole traders, there has been a 3% decline as a percentage of the business population in the same period which further serves to highlight the popularity of the company form in recent years.[19]

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14 The DBEIS figures in relation to unregistered businesses without employees is based on a combination of data from the Interdepartmental Business Register, HMRC self-assessment data and estimates from the Office of National Statistics Labour Force Survey ("**LFS**"). The LFS is a quarterly sample survey of approximately 34,000 households and may be subject to error on that basis. It also does not ask respondents to disclose whether they operate as a sole trader or in partnership. In relation to the HMRC self-assessment data, the number of partners and partnerships identified is based upon individual returns, rather than partnership returns, which yields approximately 10% fewer partners in the figures. Some valid partnership data may therefore have been excluded. DBEIS 2020 Methodology Note (n 8) 8, 13, 23-25.

15 Business Population Estimates 2015 (n 7); Business Population Estimates Detailed Tables 2020 (n 3).

This appears to be broadly consistent with the position in the United States of America. Whilst the most up-to-date census figures are not yet available in detailed form, in 2011, the Census Bureau reported that approximately 8% of the overall business population (2.2 million businesses) operate in partnership forms: Census Bureau, *Country Business Patterns* <https://www.census.gov/programs-surveys/cbp.html> accessed 3 April 2022. See also: Kyle Pomerleau, *An Overview of Pass-through Businesses in the United States*, Tax Foundation Special Report, January 2015 <https://files.taxfoundation.org/legacy/docs/TaxFoundation_SR227.pdf> accessed 3 April 2022.

16 Business Population Estimates Detailed Tables 2020 (n 3).

17 Adam, Miller and Pope (n 1) 5: 'Of this 39% cumulative increase [in the workforce between 2008-2017], just over one-third (36%) is attributable to an increase in company owner-managers and just under two-thirds (64%) is an increase in self-employment. This translates into a larger proportional increase in the company owner-manager population, which has almost doubled since 2008.'

18 Business Population Estimates Detailed Tables 2020 (n 3).

19 Adam, Miller and Pope (n 1) 5.

Ordinary partnerships represent just one of two business forms that have suffered a decline in numbers between 2015-2020.[20] The headline figures paint a particularly bleak picture. However, there are additional observations to be made. Firstly, the fall in the number of ordinary partnerships as a percentage of the business population has generally been slow, and slowing, since 2015. In fact, between 2018-2019 the number of ordinary partnerships only fell by 160 (<0.1%); the reported decline is negligible, especially if one considers the concerns about the ability to obtain accurate statistics in relation to the number of ordinary partnerships. More significantly, the DBEIS 2019-2020 figures evidence the first increase in the number of ordinary partnerships since 2014 (+2.1%, a total increase of 8,685), which accounts for 7.7% of the increase in the total number of private sector businesses in 2019-2020 period (+0.7% more than the expected figure if the number of ordinary partnerships as a percentage of the overall private sector business population had remained stable). Secondly, there is a stark contrast in the rates of decline between non-employing ordinary partnerships (comprising part of the owner-managed business population) and those that have employees. In relation to the former, the reduction in overall numbers between 2015-2020 is 2.5% (-7,585), but the number of employing partnerships has fallen by 22.2% in the same period (-29,285), indicating that a significant proportion of the decline is attributable to employing, rather than owner-managed, partnerships. Indeed, the number of non-employing partnerships increased in both 2019-2020 (+4.9%, a total increase of 14,450) and 2018-2019 (+1.7%, a total increase of 5,065). Considering that the overall number of ordinary partnerships increased by 8,685 (+2.2%) in 2019-2020, a reported increase of 14,450 non-employing partnerships in the same year is particularly noteworthy. At least so far as owner-managed businesses are concerned, the recent data suggests that the ordinary partnership may be down but not completely out. Nonetheless,

[20] The LLP has also done so. See Chapter 3.

the ordinary partnership is undoubtedly a business form that has suffered a decline in popularity as of late; it has certainly not kept pace with the overall growth trend in the owner-managed business population.

It is undeniable that the growth in the number of owner-managed companies (the fastest growing legal form) has primarily been driven by one-director companies,[21] but that does not mean that owner-managed businesses with more than one owner-manager are not also common.[22] In addition to the above figures, recent Companies House Data,[23] illustrates that the average number of directors of a company has been steadily declining since 2012-2013 (from 1.75 to 1.63 in 2019-2020) but, by contrast, the number of shareholders in a company has been slowly increasing from 2014-2015 (from 2.10 to 2.18 in 2019-2020). Indeed, the Company Law Review presented research suggesting that 70% of registered companies had just two shareholders.[24] It is entirely possible that some owner-managers are simply allocated shares rather than adopting a director role.[25] This corresponds with the findings of the HM

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21 Made possible following the implementation of the Companies Act 2006 ("**CA 2006**"). s 155 provides that a company must have at least one director who is a natural person, but no more. s 270 further removed the requirement for a private company to have a secretary. The Act also repealed Companies Act 1985 ("**CA 1985**") s 24, which provided for joint and several liability of an individual member (who knew that the company was carrying on business with only one member) where the business was carried on for more than 6 months without at least two members.

Cribb, Miller and Pope (n 4) 5, observe that the one-director company is the fastest growing legal form.

22 Adam and Miller (n 4) 5, 10. Conclusions derived from analysis of HMRC tax records from 1997-1998 to 2015-2016.

23 Based on statistics up until the end of March each year. Companies House, Companies Register Activities, 25 June 2020 <https://www.gov.uk/government/publications/companies-register-activities-statistical-release-2019-to-2020/companies-register-activities-2019-to-2020> accessed 3 April 2022.

24 Company Law Review Steering Group, *Modern Company Law: For a Competitive Economy, Final Report I*, Department of Trade and Industry (2001) 6.8-6.9.

25 The percentage of non-employing owner-managed businesses remained steady at 75-76% (75% figure in 2018 alone) in the 2014-2019 period (Business Population Estimates 2020 (n 3). Figures extracted from Companies House Table A7 (n 23). The HMRC Reasons Behind Incorporation study indicated that sometimes partners were unwilling to take on a director role… 'He [the respondent's partner] didn't want to be a director because he made such a mess of it before…although the accountant kept saying he should be a director': Ipsos MORI Social Research Institute, *Reasons Behind Incorporation*, HMRC

Revenue & Customs ("**HMRC**") Reasons Behind Incorporation study, reporting that 53% of all respondents stated that they had one other shareholder that was not a director.[26] Given that the majority of directors of such companies are male, with an average age of 48, it is most likely that the perceived 'head of the family' would be appointed as director in such instances.[27] In any event, it appears that two director companies are nonetheless still a regular feature of the business population; 34% of the HMRC Reasons Behind Incorporation study respondents had two directors (58% were one director companies).[28] 62% of the respondents that had more than one director said that at least one of those directors was part of their family.[29] Where there are two director companies, the evidence indicates that more than half have one male and one female director, suggesting a prevalence of family configurations, which historically are likely to have operated in partnership, rather than as a company.[30] Of the partnerships still in

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Research Report 317, June 2014, 15 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/342335/HMRC_Research_Report_317_-_Reasons_behind_incorporation.pdf> accessed 4 January 2022.

26 (n 25) 15. Calculated on the basis that 79% of respondents stated that they had at least one non-director shareholder, of which 26% reported having two or more non-director shareholders. There is a cautionary note contained in the Report which suggests that this figure may be an overestimate since the question related to the number of shareholders in the company without specifying that these should be non-director shareholders. It is possible that the respondents may have included themselves in the figures, though this does also mean that some of the 26% may include companies with just one non-director shareholder.

27 Cribb, Miller and Pope (n 4) 13. 75% of single director companies have a male director: 'Company owner-manager data are based on the subsample of directors where the personal record of the director is matched to the corporate record of the company. In 2013–14, this is 760,000, of whom 190,000 are directors of one-director companies." One respondent to the author's survey also noted that the same might also be true of partnerships: 'one partner usually dominates…most of our business partnerships are husband and wife…'.

28 (n 25) 1, 14. Though this may not be wholly representative of the position today. Firstly, the study was conducted in relation to businesses incorporating in 2010/2011, and the growth in one director companies since that date has undoubtedly been significant with such companies now likely to comprise a greater percentage of the business population. Secondly, as with any quantitative study, it is possible that this is not representative of the business population even at the relevant date.

29 (n 25) 15: 'This proportion was particularly high among companies who said that they incorporated because of tax or NI savings (87%)'. See Chapter 4 for further discussion.

30 Cribb, Miller and Pope (n 4) 14, though the tax records used for analysis were not used to check if the directors resided at the same address in such instances. In other cases, most two-director companies have two male owners.

Paul Davies, Sarah Worthington and Christopher Hare, *Gower: Principles of Modern Company Law* (11th edn, Sweet & Maxwell 2021) 5: 'At first sight…the critical difference between partnerships and

operation, Cribb, Miller and Pope[31] believe that more than 70% of them also have a husband and wife configuration. This appears consistent with the most recent DBEIS estimations that indicate that the average number of partners in a partnership is low, standing at just 2.4 partners per partnership. The average is no doubt elevated by the existence of larger professional partnerships, with the majority of owner-managed partnerships being confined to just two partners. That being the case, it is a fair assumption that small family businesses, involving more than one owner-manager, are still operating in substantial numbers and are therefore deserving of academic attention. This also calls for reflection upon the reasons behind the decline in the number of ordinary partnerships, given that historically this would have been the preferred form for such businesses.

1.2 A PARTNERSHIP FOCUS

Academic research has primarily been driven by consideration of the corporate form, which is unsurprising given its ever increasing popularity. The deficiency was duly highlighted by Freedman and Godwin back in 1994; '[i]t would appear that, in so far as the issue is considered at all, the limited liability company is of more interest to the small business research community than are unincorporated forms…'. [32] Unfortunately, the gap persists. To the extent that unincorporated forms are considered in the literature, there is an overwhelming tendency to combine the discussion of sole traders and ordinary partnerships, often to the detriment of the latter. The failure to view the ordinary partnership as worthy of separate consideration is not

companies lies in the former being used to carry on small businesses and the latter larger ones…such a differentiation previously had some currency, since the mid-Victorian legislature was apparently animated by just such an idea.' However, that distinction no longer holds.

31 (n 4) 14.

32 Judith Freedman and Michael Godwin, 'Incorporating the Micro Business: Perceptions and Misperceptions' in Hughes and Storey (eds), *Finance and the Small* Firm (Routledge 1994) 234.

confined to the academic arena but is a real-world problem too. The Office of Tax Simplification ("**OTS**") has previously admitted that, in relation to tax matters, partnerships are often treated as an afterthought, or even ignored, in tax design.[33] The author intends to take the first steps towards putting the spotlight onto partnerships thereby generating a meaningful discussion about their downfall, and their future potential in the owner-managed business arena. Crucially, it is submitted that in doing so, the clearest evidence of the distortionary effects of the UK tax system become apparent.

1.3 THESIS OUTLINE

The fundamental question addressed in this thesis is: can the fall of the ordinary partnership be attributed to commercial (non-tax) considerations, or is it, at least in part, due to the distortionary effects of the tax system? The author seeks to establish, primarily using new empirical research, that the tax system is highly likely to have had a significant role to play in the demise of partnerships. That is not to say that genuine commercial considerations are irrelevant but, given that basic principles of good tax design require that taxation should not affect business form selection, the present situation must be regarded as unsatisfactory.

Chapter 2 of this thesis considers the economic viability of the partnership as an alternative to incorporation for businesses involving more than one owner-manager. The attraction of limited liability offered by the corporate form is a significant draw, but it is often incomplete, and comes with a price tag of increased administrative burdens. It also does not detract from the merits of the partnership structure which offers privacy, absolute personal

[33] Office of Tax Simplification, *Review of Partnerships: Interim Report*, January 2014 <www.gov.uk/government/uploads/system/uploads/attachment_data/file/274278/PU1619_OTS_Partnerships_Interim_report.pdf> accessed 3 April 2022.

control, and flexibility of arrangement to its owner-managers. There will, for plenty of owner-managers, be sound commercial reasons for embracing the partnership, yet it is falling by the wayside as a form of choice. This Chapter highlights that there appears to be more at stake than the purely commercial (non-tax) considerations in the selection of business form.

Chapter 3 addresses the failing of the LLP, notwithstanding some initial optimism that the form would be highly attractive to businesses of all sizes. The combination of the partnership base with added limited liability is superficially appealing but has been poorly executed. The complexity of the structure produced renders the LLP inappropriate for the vast majority of owner-managed businesses and means that it is not a feasible alternative to the partnership or company. It is unsurprising that the overall reception has been lukewarm, and the LLP has broadly been reserved for use by those who advocated for its introduction i.e., large professional businesses. Due to the lack of uptake by owner-managed businesses, the introduction of the LLP cannot account for the decline in number of ordinary partnerships, which may also cast doubt on the lure of limited liability (if only to a limited extent given the defects associated with the LLP form).

Chapter 4 explores the unfortunate truth that numerous acts of incorporation are, and have been, driven by tax considerations, rather than the sound commercial reasons discussed in Chapter 2. Though this is not headline news to those familiar with the area of study, the author presents research confirming that tax matters appear to be heavily influencing the advisory process in relation to the selection of business form. The ability to access favourable tax rates by operating as a company is, understandably, too hard to resist by owner-managers that rely upon maximising their take-home returns from their business. Even where the savings are minimal, they appear to be at the forefront of many decisions to incorporate. This,

ultimately, is likely to have a significant impact upon the number of ordinary partnerships and consequently also violates key fundamental principles of tax design. The availability of a double tax saving – perhaps exaggerated by artificial levels of income splitting - in the corporate form for would-be partners leaves the partnership as the most vulnerable form for tax-motivated incorporation.

Chapter 5 notes that ill-informed owner-managers that have incorporated with a view to making tax savings may find themselves locked-in to the company form due to the application of tax charges upon disincorporation (in addition to the administrative issues encountered and discussed in Chapter 2) and presents further empirical data to support this point. This is easily remedied by way of introducing a disincorporation tax relief in the form detailed in this Chapter; the author adopts the view that this reform is central in the pursuit of a neutral tax system and that previous failures should not have a deterrent effect. The final section of this Chapter concludes the thesis.

The following Annexes are attached to the thesis:

- A brief introduction to partnerships and companies (Annex A);
- The empirical research methodology (Annex B);
- A copy of the author's primary survey (Annex C);
- A copy of the author's follow-up survey (Annex D);
- A postscript on decoupling as a potential path forward (Annex E).

CHAPTER 2: COMMERCIAL CONSIDERATIONS IN THE SELECTION OF BUSINESS FORM

2.1 INTRODUCTION

The primary purpose of this Chapter is to consider the non-tax related commercial considerations that might account for the rise of the company and fall of the partnership since the turn of the century. To this end, it presents the findings of empirical research conducted by the author alongside previous studies and academic commentary. The parallel study of focus is the HMRC Reasons Behind Incorporation Report, published in 2014, this being the most comprehensive recent comparable study to that conducted by the author.[34] This is combined with the findings presented by Freedman and Godwin following empirical research with micro businesses between 1990-91.[35] Single person owner-managed businesses are not directly considered in the author's work since operating in partnership is not viable without complex business structuring.[36]

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[34] (n 25). The study was commissioned by HMRC to gain a better understanding of the motivations behind incorporation which included focusing on what types of businesses choose to incorporate, the factors that influenced their decision, their perceptions in advance of incorporation and their experiences of the process since being incorporated. Ipsos MORI carried out a telephone survey of 1,004 businesses from 20 November to 26 January 2014. Further qualitative interviews with 30 respondents that had stated that tax had influenced their decision to incorporate/was a benefit of incorporation took place between 13 January and 4 February 2014. The Respondents to the survey were samples of the total population of nano and micro businesses incorporating in 2010/11. 66% of the survey respondents had a turnover of less than £100,000 per year in their most recent financial year. 24% had a turnover of less than £25,000, representing the smallest businesses. 35% of the respondent companies incorporated with two directors, with 34% continuing with two directors at the time of the survey – notionally the sorts of companies that could feasibly operate as partnerships. This explanation is a summary of pages 1-2,13-14 and 112.

[35] (n 32).

[36] For example, when an owner-manager forms one or more companies, in which they are the sole shareholder and forms a partnership with the company. Where the partnership is between an owner-manager and a company, this is termed a mixed-member partnership. Profit and loss allocations in mixed-member partnerships are subject to the scrutiny of the anti-avoidance provisions contained in the Income Tax (Trading and Other Income) Act 2005 ("**ITTOIA 2005**"), ss 850C-850.

The possibility of reforming the law to permit single member LLPs has been teased, but not pursued. Office of Tax Simplification, *SEPA: Sole Enterprise with Protected Asset, Final Report*, November 2016, 23

2.2 ACCOUNTING FOR THE DECLINE – COMPANY ADVANTAGES

Notwithstanding the fact that the partnership 'affords a suitable framework for a small association of persons having trust and confidence in each other',[37] Henning argues that it has lost pre-eminence largely because of the relative advantages of incorporation.[38] Following the HMRC Reasons Behind Incorporation study,[39] the OTS Small Company Taxation Review concluded that the three main advantages associated with the incorporation of an owner-managed business [that the partnership cannot offer] are:[40]

1. Limited liability;

<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/563407/SEPA_final_report_271016.pdf> accessed 3 April 2022: 'Allowing single member LLPs is something that would have to be considered in the context of policy around LLP's generally and is not something the OTS has explored…'. See also Denise Fletcher, Jane Frecknall-Hughes and Stephen Williams, *Understanding Limited Liability Partnerships in the Small and Medium-Sized Business Sector*, Institute of Chartered Accountants in England and Wales (2013), 11 <https://www.icaew.com/-/media/corporate/files/products/tax/understanding-limited-liability-partnerships-in-the-small-and-medium-sized-business-sector.ashx> accessed 3 April 2022.

37 Gower (n 30) 4.

38 Johan Henning, 'Partnership law review: the joint consultation papers and the Limited Liability Partnership Act in brief historical and comparative perspective', (2004) Company Lawyer 163, 165.

39 (n 25) 2, 3, 27, 28.

40 Office of Tax Simplification, *Small Company Taxation Review*, March 2016, 3, 25, 27, 28, 79 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/504850/small_company_taxation_review_final_03032016.pdf> accessed 3 April 2022. The OTS adopts the definition micro business contained in the Small Companies (Micro-Entities' Accounts) Regulations 2013, SI 2003/3008, as one that has a turnover of not more than £632,000, a balance sheet total of not more than 316,00 and not more than 10 employees. At the time of publication, there were 4.1 million micro businesses in the UK with 1.3 million operating through a company structure. However, the review was focused on even smaller businesses, namely, those with less than £30,000 turnover (accounting for £5.4 billion of tax receipts in tax year 2009-10), with some consideration of business with less than £70,000 turnover (accounting for £9 billion of tax receipts in tax year 2009-10). See: Office of Tax Simplification, *Small Business Tax Review: Final Report, Simpler Income Tax for the Smallest Businesses*, February 2012 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/199180/02_ots_small_business_tax_review_simpler_income_tax_280212.pdf> accessed 3 April 2022; Joseph McCahery and others, 'Traditional and Innovative Approaches to Legal Reform: The 'New Company Law', European Business Organisation Law Review (2007) 7; The Research Institute of Economy, Trade and Industry Discussion Paper Series 07-E-033, 2006 <http://www.rieti.go.jp/jp/publications/dp/07e033.pdf> accessed 3 April 2022, makes similar observations with limited liability described as a 'strong incentive'.

2. Enhanced credibility;
3. A more formalised business structure.

The omission of tax treatment in the above list is noteworthy, and somewhat suspect for a tax-orientated review, though this matter is explored further in Chapter 4.

Between April-June 2020, the author conducted empirical research with accountants to determine the extent to which the above listed advantages of incorporation affect the decision to advise owner-managed businesses to adopt different legal forms. It also explored the advantages and disadvantages of operating through a partnership today, in addition to how various taxation-based considerations might feature in the form selection process. It further invited views upon the relative advantages and disadvantages of the LLP. Accountants, rather than business owners, were selected as the target audience on the basis that it was likely that they would have more extensive knowledge in relation to the full range of legal forms available to owner-managed businesses than the owners themselves (though this assumption is not universally true). Furthermore, the HMRC Reasons Behind Incorporation Report found that the majority of companies surveyed (63%) received paid help or advice in seeking to incorporate, and 19% of respondents said that the idea to incorporate had come directly from an accountant.[41] This is to be expected given the observation [by HMRC] that '[r]espondents typically had limited advance knowledge about incorporation, with 37 per cent saying that they knew a great deal or fair amount about it, 36 per cent knowing just a little and 27 per cent knowing nothing about it.'[42]All accountants approached for the author's research were asked

41 (n 25) 2, 20-23.

42 (n 25) 24. To some extent, this makes the growth in the incorporated owner-managed business population even more striking.

to confirm that they were currently engaged in the relevant advisory process before commencing the survey.

2.2.1 Limited Liability[43]

Historically, limited liability has not always attached to the corporate form.[44] Over time, the link has become effectively universal,[45] and is facilitated by the independent legal personality of the company.[46] Today, limited liability is typically regarded as crucial for business owners.[47] It serves, in theory, to protect individuals from personal claims made against them in respect of the business' obligations and liabilities – the latter typically being linked to business debt. Presented in this way, the attraction is obvious. Whilst limited liability is often associated with

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43 The limited liability company has played a foundational role in creating the modern economy: Tim Harford, BBC World Service, *50 Things That Made the Modern Economy*, 4 September 2017 <http://www.bbc.co.uk/news/business-40674240> accessed 3 April 2022.

This section does not consider the issue of moral hazard, or the desirability of offering limited liability to small businesses. For literature on the moral hazard element see: Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' University of Toronto Law Journal (1980) 117; Henry Haansmann and Reinier Kraakman, 'Toward Unlimited Liability for Corporate Torts', Yale Law Journal (1991) 100.

As observed by Crawford and Freedman (n 5) 1042: 'Although called limited liability *companies*, it is actually the liability of the shareholder rather than that of the company, which is liable to the full extent of its assets.'

44 See, for example: Paul Davies, *Gower and Davies' Principles of Modern Company Law* (6th edn, Sweet & Maxwell 1997) 40-46 and Phillip Blumber, 'Limited Liability and Corporate Groups*'* (1986) Journal of Corporate Law 573.

45 John Armour and others, *'*What is Corporate Law?*'* in John Armour and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2017).

46 Gower (n 30) 37.

47 Not all modern finance scholars regard limited liability as being the key, but rather focus on the commercial efficiency of asset partitioning which is an inherent feature of the corporate form. See, for example, Henry Haansmaan, Reiner Kraakman and Richard Squire, 'The Law and the Rise of the Firm' Harvard Law Review (2006) 1333; Henry Haansmaan and Reiner Kraakman, 'The Essential Role of Organisational Law', Yale Law Journal (2000) 387. To some extent, the partnership exhibits asset-partitioning rules, certainly more so than the sole trader, but not to the same level as the corporation; Andreas Televantos, 'Partnership as Organisational Law' in Andreas Televantos *Capitalism Before Corporations: The Morality of Business Associations and the Roots of Commercial Equity and Law* (OUP 2020).

separate legal personality, the two are not necessarily synonymous and therefore ought to be considered separately.[48] At present, complete limited liability protection is not available when operating through any type of unincorporated business form in the UK,[49] and partners cannot restrict liability to partnership funds by the insertion of a provision in the partnership agreement, even where creditors are aware of its existence.[50] In respect of limited liability that attaches to the company form, King explains the benefits for public companies:[51]

> [l]imited liability provides the incentive for individuals to combine their resources to form a joint enterprise on a scale that would be too large for the firm to be based on the essentially personal nature of a partnership…[s]ince the risk of investing in such companies is strictly limited, this both encourages individual investors to put their money in to risky ventures, and also makes it easier for the company to raise capital to finance their expansion.

The above statement implies that the partnership would be the more appropriate form for businesses which are 'essentially of a personal nature', but it is clear that such businesses are nonetheless choosing to incorporate.[52] Of the HMRC Reasons Behind Incorporation respondents, 13% had converted from partnerships previously engaged in the same business

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48 For example, Scottish partnerships are afforded separate legal personality but do not have the benefit of limited liability. The OTS once proposed a form of limited liability for sole traders, that did not co-exist with separate legal personality ("**SEPA**") (n 36) 30-31.

49 Whilst the limited partnership, established under the Limited Partnerships Act 1907 ("**LPA 1907**"), offers limited liability to some partners, it is only provided to partners that are excluded from all management functions, broadly construed. Morse takes the view that the limited partnership was 'doomed' as a general business medium because of the weak form of limited liability provided, citing the management condition as an example of the 'fragile' protection offered for investors: Morse (n 12) 1.

50 Gower (n 30) 39. Liability could be limited by way of express, direct, agreement with the creditors.

51 Mervyn King, *Public Policy and The Corporation* (Chapman & Hall London 1977) 26.

52 Crawford and Freedman (n 5) 1041: 'Although most large firms will be incorporated, it does not follow that most unincorporated firms are large. Legal status is not a proxy for size… Incorporation does not encourage growth so much as anticipate or even follow on from growth.'

(8% had converted and formed a different business)[53] and, in a similar fashion, 96%[54] of the respondents to the author's empirical research confirmed that they had assisted an existing partnership with a corporate conversion. Indeed, both economic and legal literature generally tends to champion the limited liability associated with the company form, even for owner-managed businesses.[55] Palmer's Company Law notes the 'perils' of partnership:[56]

> [t]he law does not allow a sole trader to separate his private wealth from the funds he uses in his business and those generated by it. In other words, the sole trader's private wealth is available to pay his business debts, notwithstanding that modern tax law has no difficulty in recognising for the purposes of income tax valuation "part of a taxpayer's activities…as a self-contained trade". Consequently, the position of a single trader in ordinary law is fraught with danger: a misfortune in his business affairs which may be due to an event beyond his control or a miscalculation may jeopardise his home and savings and expose him and those depending on him to penury. The prudent businessman will avoid this risk by carrying on his business as a private company.
>
> The position of a partner is potentially even worse. Partnership is based on a relationship of mutual trust and confidence between partners, and if one partner abuses that confidence he may commit his co-partner or partners to potentially crippling liability…This risk is eliminated by conversion of the partnership business into a private company. For not only the amount at stake is limited, but the agency of the directors is restricted by articles which persons who wish to contract with the company can consult at the Register of Companies.'[57]

The purported protection offered by limited liability was the most common reason provided for incorporation of a small business during the HMRC Reasons Behind

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53 (n 25) 18.

54 217/226. Percentage of respondents based on number of people that had access to the question. This question was not available to those who had not advised an owner-managed business to form/operate as an ordinary partnership.

55 Freedman and Godwin (n 32) 234-242.

56 Geoffrey Morse (ed) *Palmer's Company Law* (Sweet and Maxwell 2021) 2.202. Quoted reference from Lord Radcliffe, *Sharkey (Inspector of Taxes) v Wernher* [1956] AC 58, 84.

57 3 free text responses to the author's survey expressed concern about the joint and several liability of partners.

Incorporation study; 24% of respondents cited this reason unprompted and 78% of respondents cited it as a reason when prompted.[58] The following breakdown is provided in the report:[59]

> Respondents were more likely to say that they decided to incorporate because of protection through limited liability if they:
>
> - Prior to incorporation were self-employed (26% of whom protection through limited liability was among the main reasons for incorporating), a sole trader (28%), a director (27%) or not working (31%), while those employed were less likely to cite this reason (19%);
> - Had lower personal remuneration (26% of those with remuneration of under £25K had liability as a reason vs. 17% of those who earned £25K to under £50K);
> - Had a lower turnover (27% of those with a turnover under £50K in 2012/13 compared with 17% of those with a turnover of £50K to £100K); and
> - Knew at least a fair amount about incorporating beforehand (30%, vs. 20% who know just a little or less).

This is also consistent with the results of the empirical research conducted by Freedman and Godwin – out of a list of thirteen possible advantages of incorporation, limited liability was considered as important by the majority of micro business respondents.[60]

> Those referring to limited liability as important broke down as follows: limited liability to suppliers important (46.4 per cent), limited liability to banks and financiers (45.6 per cent), limited liability to customers (33.6 per cent), limited liability to other shareholders (16.8 per cent).[61]

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58 HMRC Reasons Behind Incorporation (n 25) 28.

59 HMRC Reasons Behind Incorporation (n 25) 28.

60 Freedman and Godwin (n 32) 245-246. Though one in seven (14.4%) stated that limited liability was *not* important, and 19.2% did not make any response relating to limited liability. The study obtained information from '429 in different geographical areas using a combination of mail questionnaires and telephone interviewing. The sample included equal numbers of incorporated and unincorporated firms.' For a detailed account of the methodology see 275-277.

61 Freedman and Godwin (n 32) 246.

Furthermore, 51% of the HMRC Reasons Behind Incorporation respondents reported that prior to incorporation they had received advice (40% paid and 11% unpaid) that incorporating would reduce their personal liability.[62] The Taylor Report cautiously observes that '[a]n increasing number of people are providing their labour through a company structure. This *may* [emphasis added] be to access limited liability...'.[63] The OTS is significantly more confident: 'there are of course many other reasons for incorporating a business…but…we [the OTS] are satisfied that limited liability protection is a major driver…'.[64] Considering the high rates of failure for small businesses, which may be linked to a need to obtain early years funding (often from a bank),[65] the offer of limited liability, seemingly achieved by operating through the company form, is clearly attractive to owner-managers.[66] Indeed, in 2016 it was reported that just four in ten small companies would still be trading after five years,[67] with the construction sector being identified as one that experiences significant difficulties.[68] 'The failure rate is very high. It is estimated that only 30% of family businesses make it to the second

62 HMRC Reasons Behind Incorporation (n 25) 24.

63 Taylor Review (n 1) 69.

64 OTS SEPA Final Report (n 36) 5.

65 British Business Bank, 'Small Business Finance Markets' 2015/16, <https://british-business-bank.co.uk/wp-content/uploads/2016/02/british-business-bank-small-business-finance-markets-report-2015-16.pdf> accessed 3 April 2022.

66 Cribb, Miller and Pope (n 4) 33.

67 Ben Lobel, 'Business failure: Four in ten small companies don't make it five years <http://smallbusiness.co.uk/business-failure-four-ten-small-companies-dont-make-five-years-2533988/> accessed 3 April 2022.

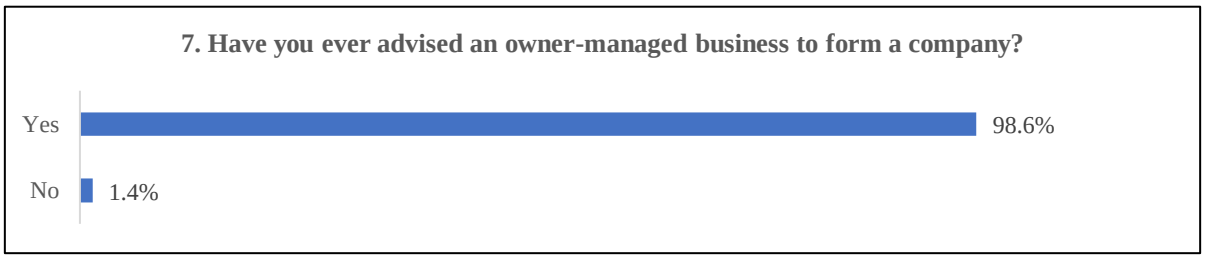
68 Peter Rayney, 'Incorporation of a Business' in Rebecca Forster, *Tolley's Tax Planning 2021-22* (Lexis Nexis 2021) 27.6; 'The protection of limited liability can be valuable against… financial risks and for this reason is particularly important for certain types of businesses, such as builders'; Elizabeth Anderson, 'Half of UK start-ups fail within five years', *The Telegraph*, 21 October 2017, <http://www.telegraph.co.uk/finance/businessclub/11174584/Half-of-UK-start-ups-fail-within-five-years.html> accessed 3 April 2022. Anderson notes that businesses in the wholesale and retail sector are more likely to survive the first year of trading.

generation of family ownership, with some 13% surviving to the third generation and just 3% beyond that… the 30:13:3 rule.'[69]

35% of the HMRC Reasons Behind Incorporation respondents that had ceased trading stated that they had done so within just one year of incorporation, whilst another 43% were trading for more than one year and up to two years. Just 21% of the businesses that had ceased trading had done so after more than two years of operation, highlighting the difficulty of establishing a successful business in today's economic climate. Perhaps it also demonstrates that a significant proportion of people enter into business whilst underestimating the challenges posed or with, quite simply, bad (unprofitable) ideas.[70]

98.6%[71] of the respondents who engaged with the author's research confirmed that they had previously advised an owner-managed business to form a company thereby affirming the company's prevalence.

Figure 2: Percentage of accountants that have advised an owner-managed business to form a company



69 Peter Rayney, *Rayney's Tax Planning for Family and Owner-Managed Companies 2020/21* (Bloomsbury Professional 2020) 60.

70 Cribb, Miller and Pope (n 4) 33.

71 348/353. Response percentages are based upon the number of responses per question, rather than number of participants. Except for questions 1 (confirming that over the age of 18) and 2 (confirming that currently engaged in offering owner-managed businesses in relation to form) all questions were made optional to ease in the completion of the survey. All response figures are referenced in the footnotes contained herein.

The survey asked the respondents to what extent they agreed[72] that the following are advantages of forming/operating through a company for owner-managed businesses:

- Limited liability;
- Separate and continuing legal personality;
- Financing options (such as the ability to offer floating charges);[73]
- Pension flexibility;
- Formal business structure;
- Prestige/credibility;
- Ability to satisfy customer requirements;
- Ability to sell/transfer shares;
- Tax treatment.

As expected, 'limited liability' attracted the highest number of 'strongly agree' (69.3%)[74] responses and the greatest percentage figure of overall agreement. When combined with 'agree' responses, 98.3%[75] of the participants agreed that limited liability was an advantage of operating through a company.

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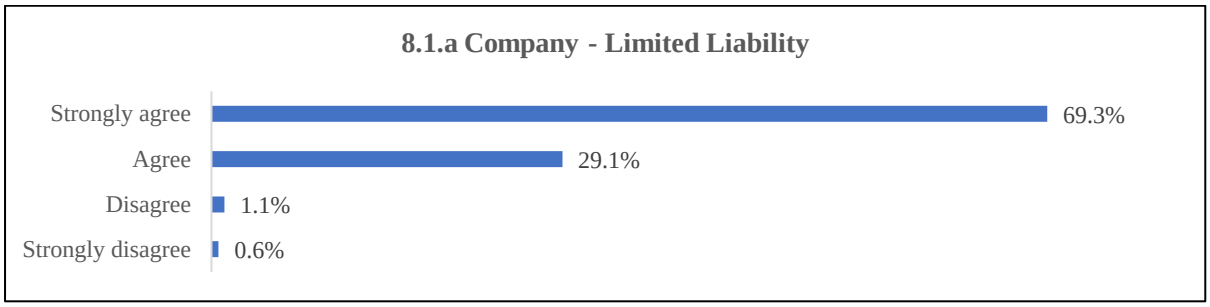
72 The options were: strongly agree; agree; disagree; strongly disagree, and; don't know. 53 participants offered additional comments on this question (explored in detail below, where relevant), 5 of whom suggested that a 'subject to circumstances' (or similar) option was the best response to each. This option was deliberately omitted from the survey as it was anticipated that its inclusion would impact upon the quality of the data, as it would be likely to attract the majority of responses and cannot give a helpful overall impression of accountant's views on the topic. The 'don't know' option was intended to provide an alternative for those who felt unable to answer the question(s) as presented. 1 participant indicated that he had done this. To ensure consistency across the survey, this approach was adopted for all similar questions (though see Chapter 3 for discussion of a mistake in relation to one LLP question).

73 For information on typical sources of finance for businesses see: Office of Tax Simplification, *Business Lifecycle Report: Simplifying the Taxation of Key Events in the Life of a Business*, April 2018, 18-22 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/699972/OTS_Business_Lifecycle_report_final.pdf> accessed 3 April 2022.

74 250/361.

75 355/361. Percentages in Figure 3 are rounded up; 98.3% is the true overall statistic.

Figure 3: Agreement that limited liability is an advantage of the company[76]



Individuals that confirmed that they had advised owner-managed businesses to form a company were further questioned as to the types of business (by industrial sector) that they had advised in this way. Their views were also invited upon the extent to which limited liability was important in each of those sectors.[77]

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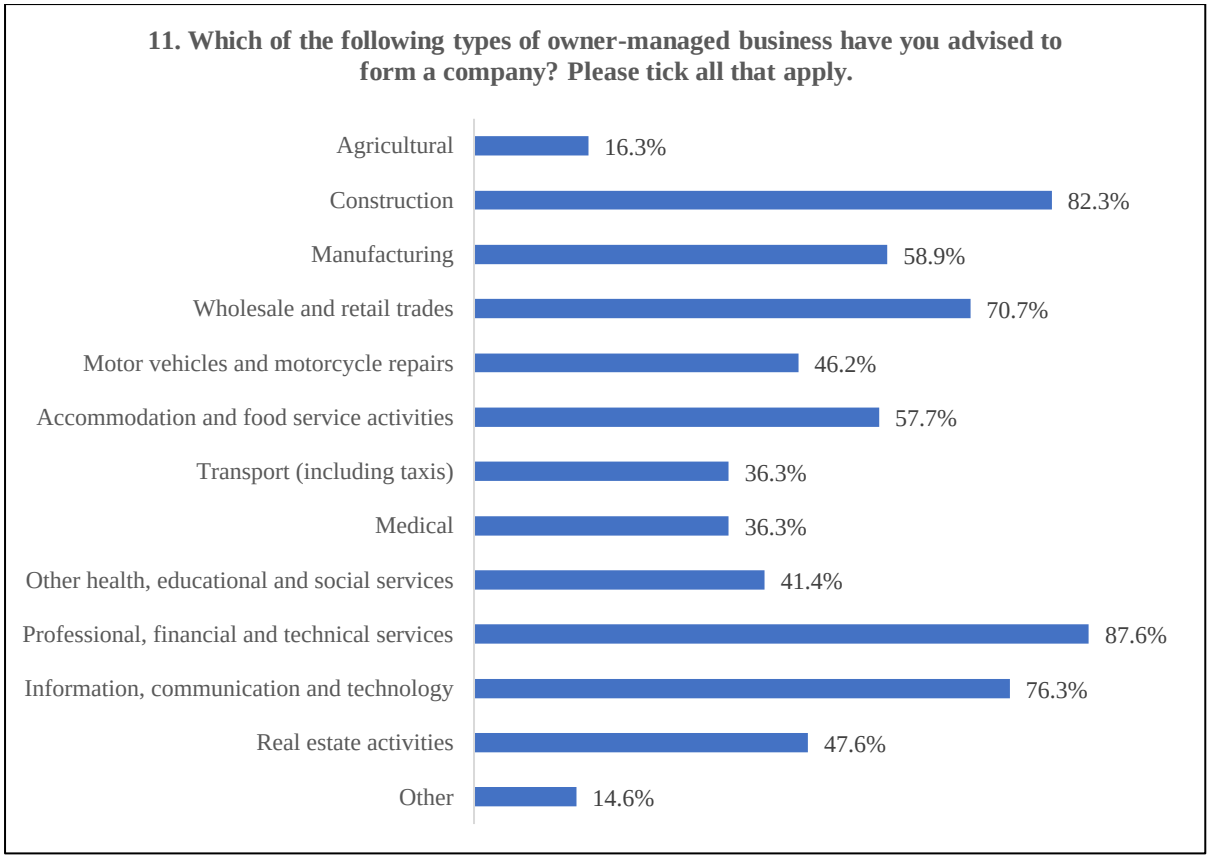
76 0 'don't know' responses were returned.

77 The list is based upon, though not an exact replica of, the industrial sector breakdown in the DBEIS Business Population Estimates. Considering the small proportion of SMEs operating in the mining, quarrying and utilities sector, these were omitted as a specified entry. The 'other' category could accommodate such businesses, but none of the 52 'other' responses indicated that their clients fell within this industrial sector. Given the seemingly high numbers of small businesses engaged in wholesale and retail trades, and repair of motor vehicles, these were separated for the purposes of the survey, as compared to the DBEIS statistics which treats the two as a single category. Minor variations were also made in relation to the technical and professional categories to enable a more detailed understanding of LLP usage, addressed later in the survey. In order to shorten the survey, administrative support service activities (SIC code section N) and arts, recreation and entertainment (SIC code section R) were removed, though these were referenced multiple times (13 for each category) in the written responses on the 'other' category. Charities were also mentioned on 6 occasions, but these fall outside of the scope of the study; this suggests that some of the respondents may not have appreciated the owner-managed business focus, notwithstanding the survey signposting. For full list of SIC codes see Companies House, *Nature of Business: Standard Industrial Classification (SIC) Codes* <http://resources.companieshouse.gov.uk/sic/> accessed 3 April 2022.

Figure 4: Percentage of accountants that have advised an owner-managed business to form a company, by reference to industrial sector[78]



The industrial breakdown, in terms of number of firms advised, was distributed in the anticipated manner. The higher percentages are associated with the industrial sectors that the DBEIS has reported as comprising the greater proportion of the SME business population.[79] In 2020, the estimates provided that the following (in order) were the largest industrial sectors: construction; professional, scientific and technical activities; wholesale/retail trade and, repair of motor vehicles and motorcycles.[80]

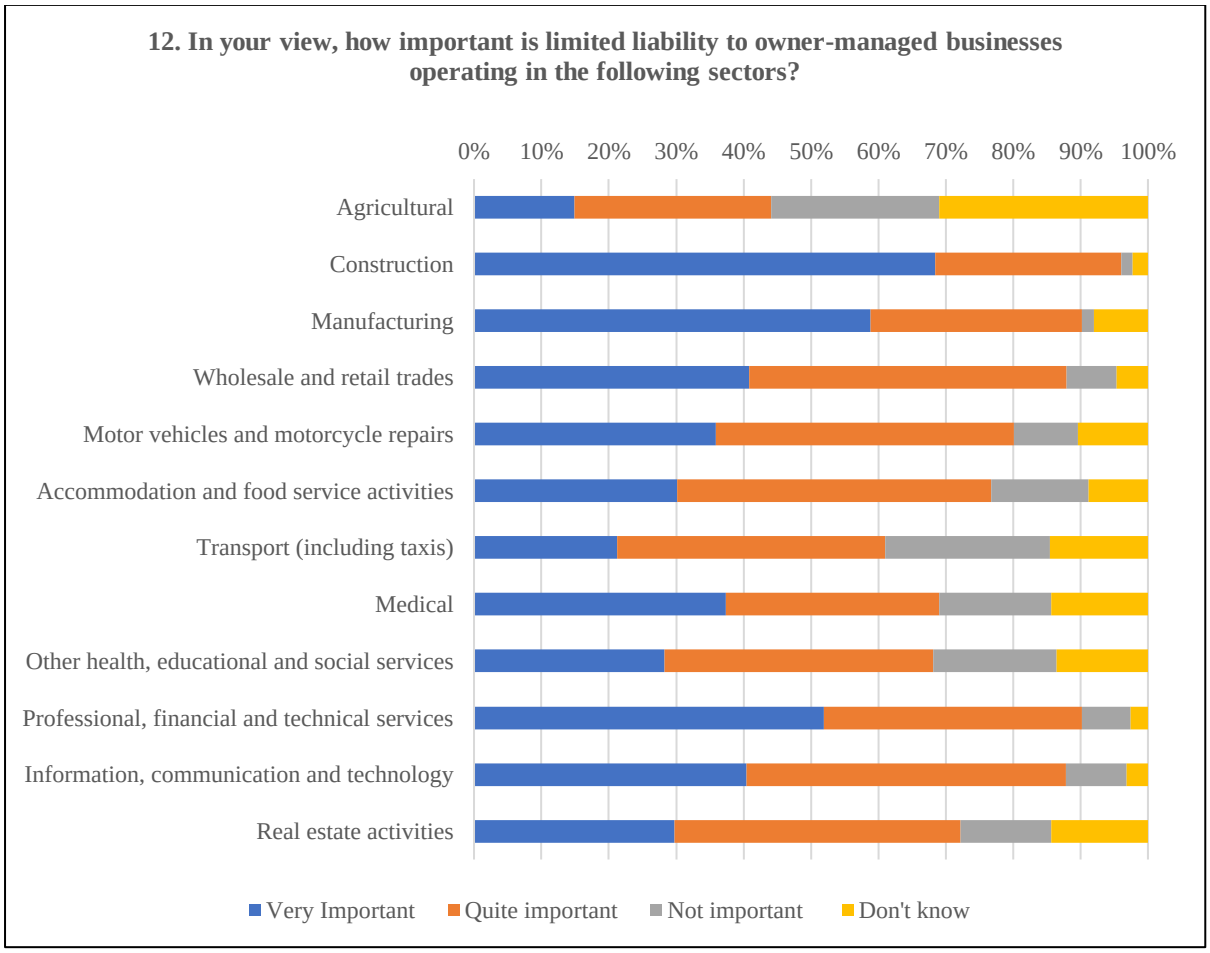
78 Multi answer: percentage of respondents who selected each answer option (e.g. 100% would represent that all this question's respondents chose that option).

79 Consistent with the distribution of respondents to the OTS Small Company Taxation Review (n 40) 113.

80 Business Population Estimates 2020 (n 3) 13. Also consistent with figures reported in earlier years (n 7).

The survey responses demonstrated a diversity of views upon the importance of limited liability in the industrial sectors, as illustrated in Figure 5, though 12 respondents offered additional comment suggesting that sector was not important in so far as limited liability is concerned i.e. it is important regardless of industrial sector.

Figure 5: Percentage of accountants that believe limited liability is important, by reference to industrial sector



Noteworthy is the high proportion of accountants that believed that limited liability was not important (33%)[81] in the agricultural sector though this may be because such businesses

[81] 19/58.

are more likely to be inherited, and less likely to have bank loans and trade creditors than other industries. Other sectors where a significant proportion[82] of the respondents indicated that they did not think that limited liability was important included: other health, educational and social services (16.9%);[83] transport (16.8%);[84] medical (14.2%);[85] real estate (12.5%);[86] accommodation and food services (12%).[87] The observation in relation to (lack of) trade creditors might equally apply to service based industries, but the inclusion of medical professions and real estate activities in the list is a little more surprising. The former run the risk of being subject to high value negligence claims (much like the accountants who pushed for the introduction of the LLP, though of course insurance will have been purchased),[88] whilst the latter are likely to have business loans to support their enterprise and have high exit rates within the first year of trading.[89]

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82 More than 10%.

83 24/142.

84 21/125.

85 18/127.

86 21/168.

87 24/200.

88 See Chapter 3. Additional comments by some respondents appear to encompass the medical profession: '[limited liability should be regarded as important in] any highly litigious sector'; 'any sector where there is exposure to significant liability due to the product or service' and 'any business where a large risk is present.'

In the Department of Health and Social Care, *GP Partnership Review: Final Report*, 2019, 22 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/770916/gp-partnership-review-final-report.pdf> accessed 3 April 2022, concerns were also expressed about the personal liability of GPs: 'An increasing level of personal risk is one of the major reasons GPs told the review that they were opting not to join partnerships, or leave them prematurely. The financial risk, whether real or perceived, largely sits with the premises ownership or lease holding, but is also associated with medical indemnity and the personal financial risk of being an unlimited liability partnership.'

89 Lobel (n 67).

Nonetheless, it is important to appreciate that even in the sectors where a significant number of accountants stated that limited liability was not important, or did not know whether it was important or not, in every case the majority indicated that limited liability was important to some extent. Given this overwhelming level of support, both in the author's survey responses and previous empirical work, for the view that limited liability is a primary advantage of operating through a company, it would be reasonable to assume that where this benefit is not accessible by owner-managed businesses, the incentive to incorporate would be diminished.[90] However, as will soon become clear, that does not appear to be true.

2.2.1.1 Insolvency

The problem for business owner-managers is that, when it comes to limited liability achieved through the corporate form, the protection is often more apparent than real; this is so even where the company arrangement is not regarded as a sham.[91] First and foremost, section 214 Insolvency Act 1986 (**"IA 1986**") makes provision for a company director to be personally liable for the debts of the company where 'at some time before the commencement of the winding up of the company, that person [the director] knew or ought to have concluded that there was no reasonable prospect that the company would avoid going in to insolvent liquidation.'[92] A person held liable under section 214 IA 1986 may also be the subject of a further disqualification order under the Company Directors Disqualification Act 1986 ("**CDA**

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90 Gower (n 30) Chapter 7 explores in detail the limits of limited liability and separate legal personality.

91 The finding of a sham is exceptional, though in *Jones v Lipman* [1962] 1 All ER 442 the following circumstances sufficed: in order to avoid an order for specific performance pursuant to a contract to sell property, Lipman transferred the property to a company which he had set up. Having determined that, in actuality, Lipman and the company were not separate entities the court held that the company was 'a creature of the first defendant, a device and a sham, a mask which [he] held before his face to avoid recognition by the eye of equity.'

92 IA 1986, s 214(2)(b).

1986"). There are constraints upon the extent of the liability: liability will only arise if it can be shown that the company is worse off (net basis) as a result of the continuation of trading;[93] the director will also not be obligated to contribute to any liquidation expenses incurred in pursuing the section 214 claim,[94] nor will an order be made if the court is satisfied that the director 'took every step with a view to minimising the potential loss to the company's creditors… as he ought to have taken.'[95] Given the existence of the constraints, the theoretical risk of liability is much higher than the likelihood of a successful action being brought by the company liquidators. Nonetheless, the existence of the risk itself amounts to a chink in the limited liability armour.

2.2.1.2 Negligence and Other Torts

There are also circumstances in which company directors may find themselves liable in tort. In this respect, there are two different types of situations that may generate liability for the director. The first involves the company commission of a tort, whereby the director has 'authorised, directed and procured the commission of a tort by their company' and personal liability may arise 'even though they were not aware the acts so authorised were tortious or did not care whether the acts were tortious or not.'[96] The second scenario is where it is the act of the director in question that gives rise to the liability of the company, though establishing

93 *Re Marini Ltd (the liquidator of Marini Ltd v Dickenson and others)* [2003] EWHC 334.

94 *Re Ralls Builders Ltd (in liquidation)* [2016] EWHC 1812 (Ch).

95 IA 1986, s 214(3). *Re Ralls Builders* [2016] ibid.

96 Palmer's (n 56) 8.2214. *C Evans & Son Ltd v Spritebrand Ltd* [1983] QB 310*; Performing Right Society Ltd v Ciryl Theatrical Syndicate Ltd* [1924] 1 KB 1 CA 14–15; *Wah Tat Bank Ltd v Chan Cheng Kum* [1975] AC 507 PC (Sing) 514–515; *Mancetter Developments v Garmanson and* Givertz [1986] QB 1212*; PLG Research Ltd v Ardon International Ltd* [1993] FSR 197 Ch D (Patents Ct) 238–239.

liability in this second instance is again difficult.[97] In either case, the courts have generally shown a reluctance to impose tortious liability upon directors, even in companies involving just one owner-manager. As with section 214 IA 1986, the risk of liability may be low here, but the possibility ought not to be ignored in the context of considering the extent of limited liability for owner-managers.

2.2.1.3 Personal Guarantees

By far the most pertinent source of individual liability for owner-managers is the personal guarantee. Numerous accounts of this area of law observe that limited liability is frequently undercut by the demands of banks for personal guarantees from the company proprietor when securing business loans.[98] This practice is not necessarily limited to the owner-manager, as personal guarantees may also be provided by friends and family. 53.6% of the respondents to Freedman and Godwin's survey stated that the directors and/or their spouses currently provided personal guarantees to banks or other creditors.[99] Whilst the practice is most common with high street banks,[100] it is possible that other forms of creditors, such as peer to peer lenders,

97 There is some disagreement as to the appropriate test to apply here. One approach involves the application of the normal rules of agency, whereas the other focuses upon whether the company is *primarily* liable for the tort. The seminal UK case considering the position of a one director company is *Williams v Natural Life Health Foods Ltd* [1998] 1 WLR 830, which seems to prefer to apply the normal rules of tortious liability to the acts of directors (the first approach described above), though the decision itself has been the subject of academic debate: Palmer's (n 56) 8.2217 – 8.2222.

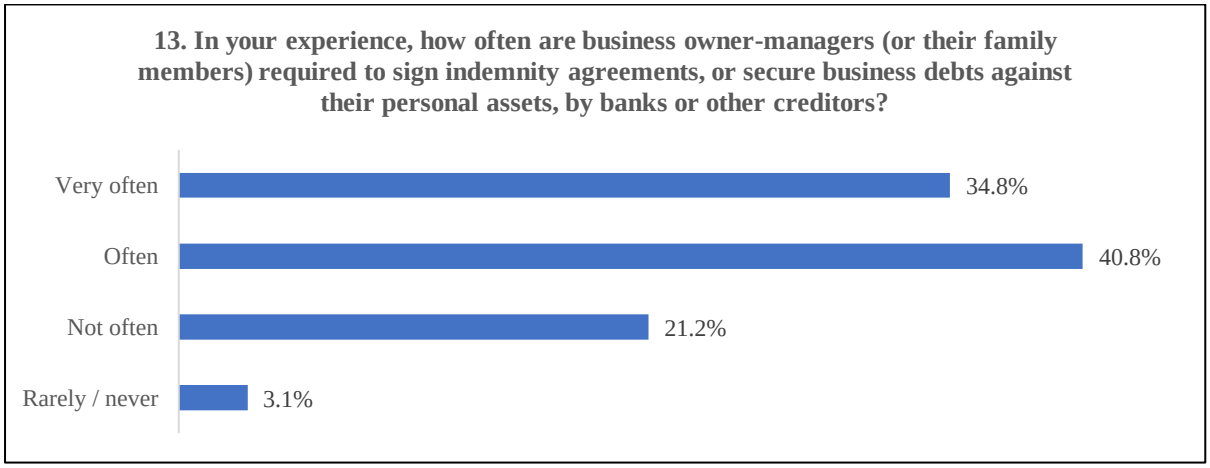
98 OTS Small Company Taxation Review (n 40) 28, 30. Judith Freedman, 'Limited Liability Partnerships in the United Kingdom – do they have a role for small firms?' (2001) JCL 897, 904: 'Small firms often gain little benefit from the apparent limited liability form, since creditors will contract around this limitation by insisting on personal guarantees. In this case, purporting to bestow limited liability could be nothing but a dangerous illusion.'

99 Freedman and Godwin (n 32) 246.

100 Freedman and Godwin (n 32) 246, 279: 'Where further information was supplied, it seemed that these guarantees were almost always given to banks…Of those providing information 81 per cent mentioned banks (including 7 per cent who also mentioned others. None per cent mentioned others (for example, suppliers and landlords) only. The remainder did not specify the nature of the guarantee.'

significant trade creditors[101] and landlords, would also require an owner-manager to provide a personal guarantee, the effect of which is to render the company proprietor, and their guarantors, liable in the same way as a sole trader or ordinary partner. The survey responses confirmed the ubiquity of this practice, with 75.6%[102] confirming that their experience was that they were required 'very often'[103] or 'often'[104] (Figure 6).

Figure 6: Experience of frequency of personal guarantees



However, there are variations in the data that become evident if cross-tabulated by reference to qualification, experience (length of time advising) and firm size. In relation to qualifications, AAT (or equivalent) qualified accountants were most likely to claim that

101 Where an owner-managed business trades in goods, some trade creditors have adopted a practice whereby ownership of the goods is not transferred to the owner-managers. In cases where the owner-managed business then becomes insolvent, the assets are returned to the trade creditors. This is an alternative to a personal guarantee which does not undermine the notion of limited liability.

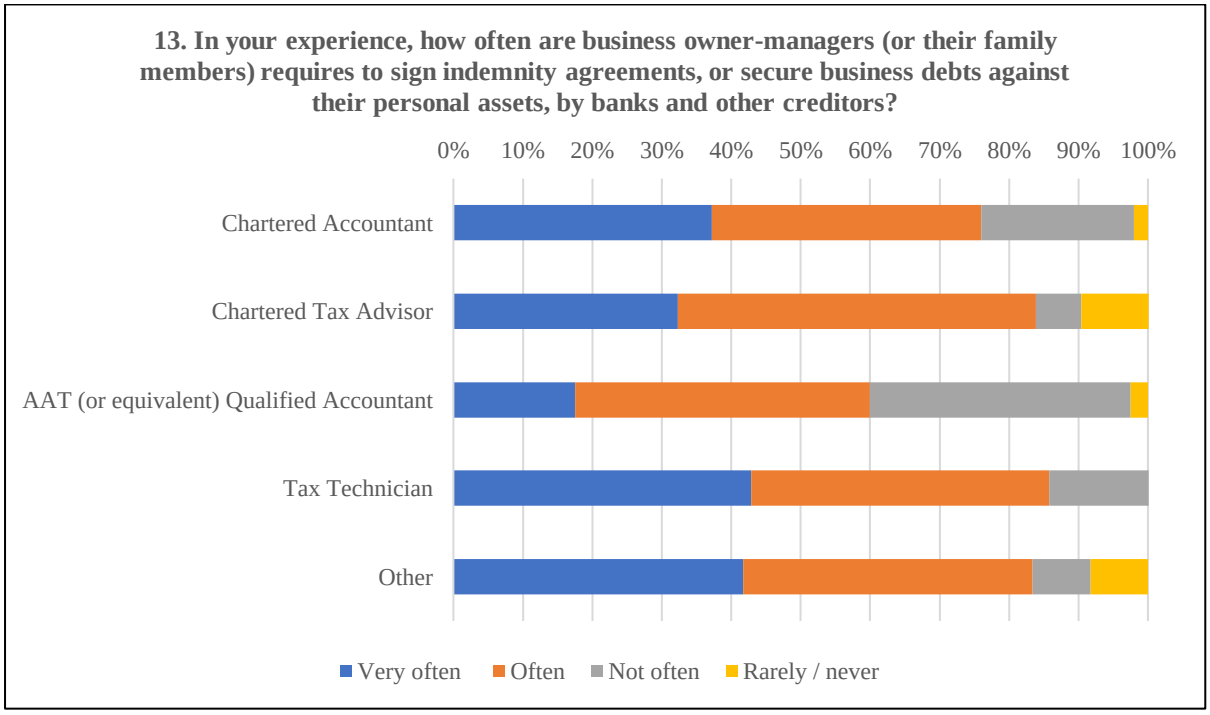
102 267/353.

103 123/353.

104 144/353.

personal guarantees were 'not often' required (37.5%).[105] It is also of note that Chartered Tax Advisors (i.e. some of the most highly qualified respondents) were most likely (9.7%)[106] to say that personal guarantees were never required.[107] That being the case, whilst the responses clearly differ between accountants with different levels of qualifications, there are no clear conclusions to be drawn based upon these differences.

Figure 7: Experience of frequency of personal guarantees, by reference to qualification



On the other hand, if experience is taken as a guide then it can be observed that, as a general rule, the more experience the respondent had the more likely they were to report that a

105 15/40. Trainee accountant data has been removed as part of the cross-tabulation process throughout the presentation of the survey results because there were only two responses – too few to make any meaningful observations.

106 3/31.

107 Perhaps significant is the fact that only 31 respondents fell within this category, so each response has a greater effect on the percentage distribution than other categories.

personal guarantee was required.[108] The 'more than 10 years' group were most likely to say that, in their experience, personal guarantees were required 'very often' (35.8%)[109] and 'often' (43.1%)[110]. The difference between this group and 1-5 years is marked;[111] just 23.8%[112] accountants in the 1-5 years category reported that personal guarantees were required 'very often' and only a further 14.3%[113] said that they were 'often' required. The most experienced were also least likely to say that 'rarely/never' was a personal guarantee required (2%),[114] though there is a small outlier in the form of the 'not often' category where the result was 2.4% higher than the 6-10 years group of accountants. The 6-10 years group were also, by a margin of 0.5%, most likely to answer 'never/rarely' so the correlation between experience and 'never/rarely' is imperfect. Most respondents to this question (84.7%)[115] fell into the 'more than 10 years' category meaning that the results therein can be taken as a reasonably reliable indicator of the frequency of the use of the personal guarantee.

108 'Less than one year' data has been removed because there were only two responses – too few to make any meaningful observations.

109 107/299.

110 129/299.

111 Though only 21 responses fell within this category.

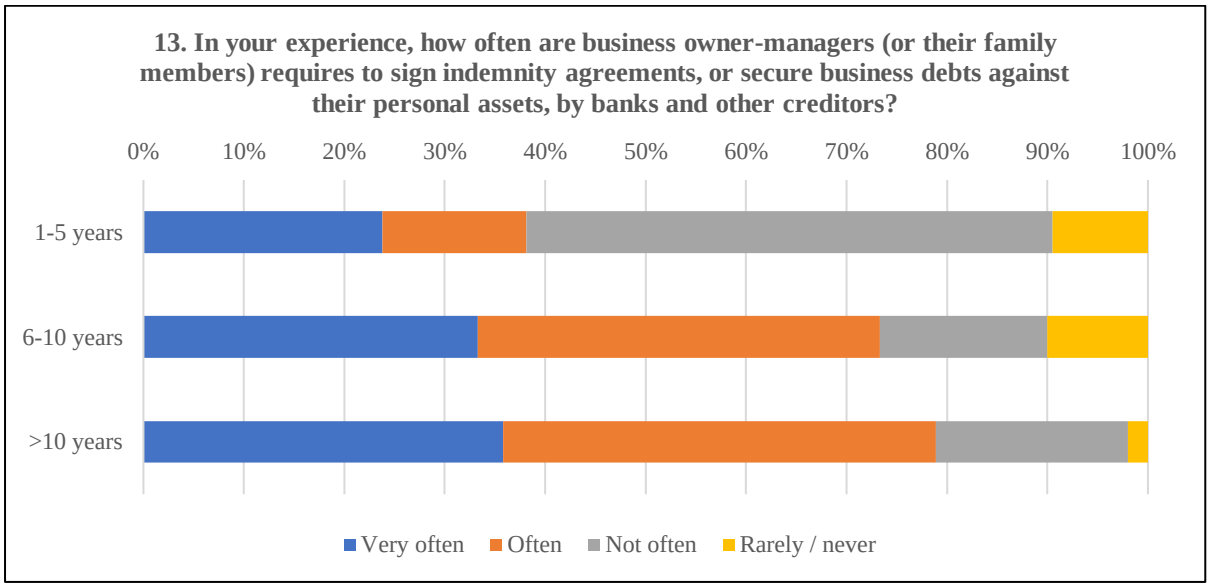
112 5/21.

113 3/21.

114 6/299.

115 299/353.

Figure 8: Experience of frequency of personal guarantees, by reference to experience



Isolating answers by reference to firm size shows another trend, namely that, if the 'very often' and 'often' answers are combined, the larger the firm, the more likely the accountant is to report that personal guarantees are frequently required. 70.2%[116] of the accountants in the smallest firms (1-2 members) indicated that the use of personal guarantees was frequent. This figure increased to 85.7%[117] for the largest firms (more than 20 accountants) (Figure 10). This correlation may be because a more profitable owner-managed business is more likely to seek the assistance of a larger (perhaps seen as more reputable) accountancy firm, but one can only speculate on that point.[118] However, if the 'very often' and 'often' categories are separated in the analysis, the picture is more complex. Indeed, a greater percentage of accountants in the middle two categories of firm size[119] selected 'very often'[120]

116 87/124.

117 36/42.

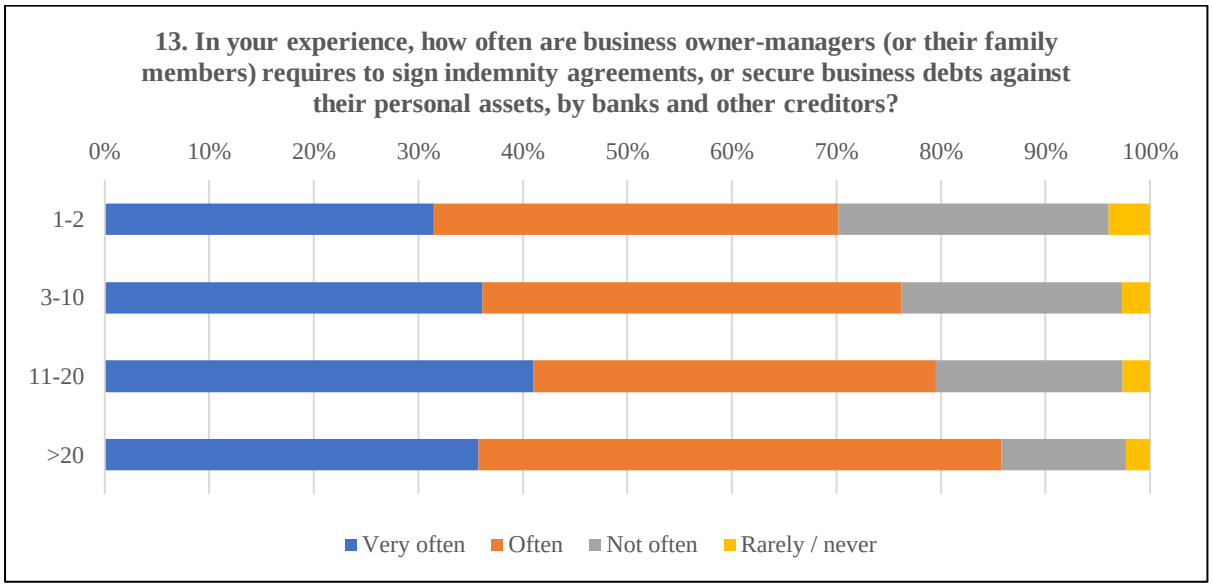
118 Additional research would need to be conducted with owner-managers to test the hypothesis.

119 3-10 and 11-20 accountants.

120 36.1% in the 3-10 category (53/147); 41% in the 11-20 category (16/39).

as a response to this question. In the combined figures this is offset by the fact that 50% of accountants in the largest firms selected 'often'.[121]

Figure 9: Experience of frequency of personal guarantees, by reference to firm size



No matter how the empirical data is dissected, it very clearly confirms that owner-managed businesses are often required to provide personal guarantees – it might even be regarded as standard practice where access to finance is required. This may account for the HMRC Reasons Behind Incorporation report finding that protection through limited liability was only cited as the third main benefit of incorporation (17% unprompted) of incorporation, three years after the incorporation date, even though it was the most cited reason for incorporation initially.[122] The OTS Sole Enterprise with Protected Asset ("**SEPA**") Report suggested that many business owner-managers would not be required to provide personal

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121 21/42.

122 HMRC Reasons Behind Incorporation (n 25) 51. 20% of the Respondents had said that they had used external sources to finance the company, 13.

guarantees since they only tend to bite, assuming a good credit score and a reasonable income, when the individual(s) needs to access a loan of more than £25,000.[123] The findings of the author's empirical research cast doubt upon this in suggesting that the practice is more widespread,[124] or perhaps the OTS is optimistically assuming that the majority of business owner-managers have both a good credit score and, crucially, a reasonable income. The latter might be unattainable in the early years of business, particularly if prior employment is fully given up pursuing the business enterprise. Even if the OTS is correct, and its assumptions true, the best-case scenario is that personal guarantees are to be expected whenever an owner-manager requires access to a substantial loan, has significant trade creditors or a savvy landlord.[125] The outcome is that the cases in which limited liability is likely to be highly valuable to an owner-manager are exactly the instances where limited liability is illusory.

Furthermore, whilst insurance is available to protect business owner-managers against the potential consequences of the personal guarantee it typically takes three years to achieve any significant level of cover - normally in the region of 70-80% - yet, as has already been explained, this is a period of great vulnerability for new businesses. In any event, based on the author's market research, it appears that at present that there is no insurance provider that will offer 100% cover. As such, the personal guarantee still has real world implications for the company owner-manager.

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123 OTS SEPA Report (n 36) 7.

124 See also the observations made by Mark McLaughlin and Jackie Anderson, *Incorporating and Disincorporating a Business* (Bloomsbury Professional 2014) 62: 'Many businesses rely on borrowings to finance their business operations. A sole trader or partner must almost always rely on secured or unsecured loans from a bank, often backed by personal guarantees and charges over personal assets. There is no reason why a family company or owner-managed company should not operate in the same fashion, though personal guarantees may still be a prerequisite.'

125 ibid. Though based upon the data it would seemingly be the case that a significant number of owner-managed businesses do require loans.

In defence of owner-managers, it might be said that questioning their motives for incorporation based upon the fact that limited liability can be illusory is misplaced because personal guarantees are sometimes 'locked away in the small print of business loans'.[126] Where the pressure to obtain finance is great, this 'small print' may not be read or questioned. There is evidence to suggest that small business owners do not necessarily understand the consequences of signing a personal guarantee. A 2015 Wirefund survey reported that out of 510 'senior' SME decision makers surveyed only 55% knew what a personal guarantee was and that a substantial number (21%) simply thought that the guarantee required the company director to personally guarantee that money will be paid on time, to the best of their ability.[127] This led Wirefund to the conclusion that it is possible that more than 2.5 million business owners potentially secured a loan against their own home or personal assets without realising that they had done so. Additionally:

> [t]here is a broad and deep misunderstanding of what personal guarantees are and the impact they have on the SME community…[p]ersonal guarantees are not fit for purpose. Business loans are built on a dangerous misunderstood practice. Not only is there a severe underestimation of personal risk by SME owners but personal guarantees do not match the typical asset ownership of today's entrepreneur either [thereby entailing significant risks for family members too].[128]

The results of this survey ought to be treated with a degree of caution as Wirefund is an alternative source of funding for small businesses advertising the fact that it does not require a personal guarantee. It also does not explain the methodological process adopted in the course

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126 Owen Gough, '*SMEs Don't Understand Personal Guarantees in Business Loans'*, 2016 <http://smallbusiness.co.uk/smes-personal-guarantee-business-loans-2535607/> accessed 3 April 2022.

127 Wirefund, '*Personal guarantees: Misunderstood and Misaligned with the Needs of British Business',* 2016 <https://www.wirefund.com/pages/personal-guarantee> accessed 3 April 2022.

128 ibid.

of its survey so it cannot be determined whether the sample is appropriately representative of the owner-managed business community; the responses were provided by '510 senior SME decision makers' (undefined). Even if the results are taken as a true and accurate reflection of the views of small business owners, 45% of those surveyed still understood the consequences of the personal guarantee and signed on the dotted line (though of course it might be the only option at that point in time).

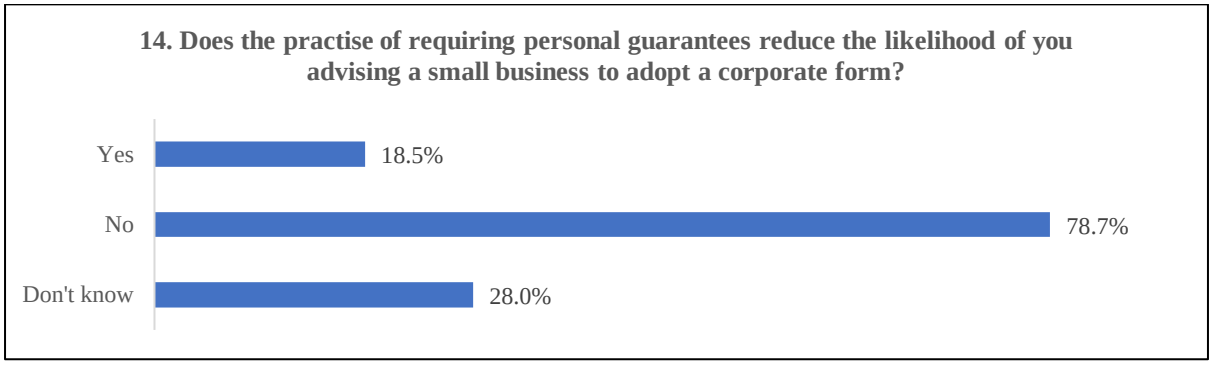
The problem is that even if it is true that company owner-managers sign personal guarantees ignorant of the consequences, such that one might be more forgiving of the misplaced belief that a company will offer limited liability in these circumstances (and therefore accepting of the assertion that limited liability is the – mistaken – primary driver of incorporation),[129] it does not appear to explain why it is that *accountants* surveyed have simultaneously reported that limited liability is the primary benefit of incorporation *and* that personal guarantees are frequently required, thereby undermining the key 'advantage' of incorporation. To explore this apparent inconsistency, the survey further asked whether the use of personal guarantees reduced the likelihood of advising owner-managed businesses to adopt a corporate form. The results affirmed the existence of the inconsistency, with 78.7%[130] of the accountants saying that it did not have the proposed affect and just 18.5%[131] reporting that it did.

[129] Even this softer conclusion would be a cause of great concern. It might even be regarded as more troubling that the owner-managed business community frequently operates upon the basis of the truth of a fundamental misunderstanding.

[130] 280/356.

[131] 66/356.

Figure 10: Relationship between the use of personal guarantees and likelihood of advising an owner-managed business to adopt a corporate form

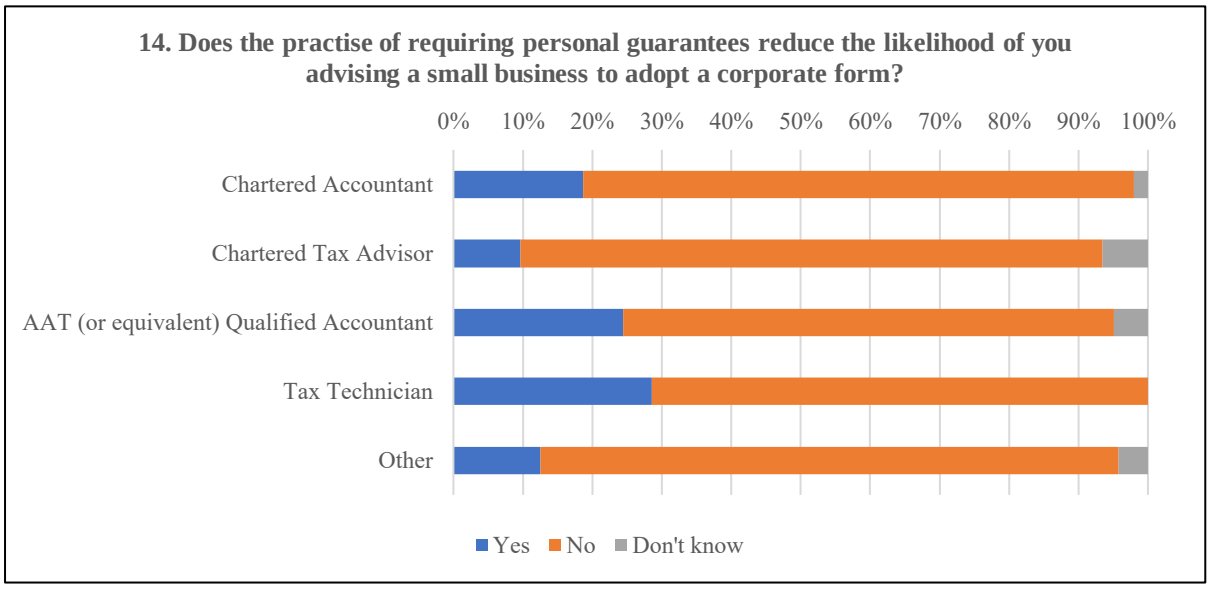


Respondents with lower-level qualifications (AAT (or equivalent) qualified accountants and Tax Technicians) were more likely to state that requests for personal guarantees made them less likely to recommend the company form for owner-managers (24.4%[132] and 28.6%[133] respectively) (Figure 11).

[132] 10/41.

[133] 2/7.

Figure 11: Relationship between the use of personal guarantees and likelihood of advising an owner-managed business to adopt a corporate form, by reference to qualification

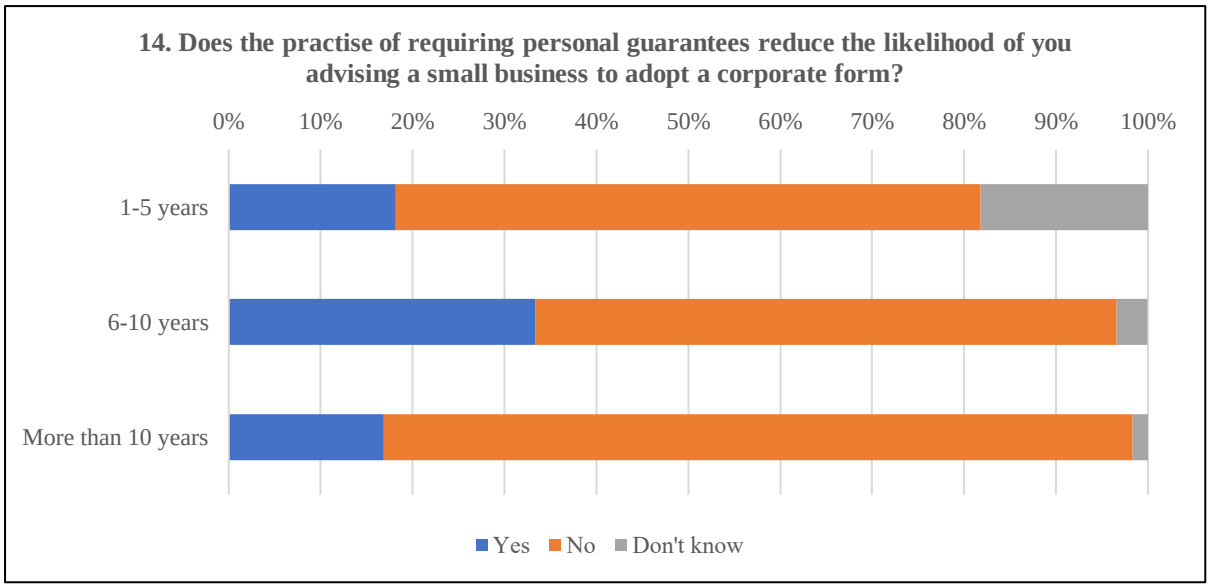


The most experienced respondents were least likely to report their advisory process being affected by concerns in relation to the personal guarantee (16.9%[134] selected 'yes'; as many as 81.4%[135] indicated that it was not), though there is no distinct overall correlation between experience and response on this matter (Figure 12).

134 51/301.

135 245/301.

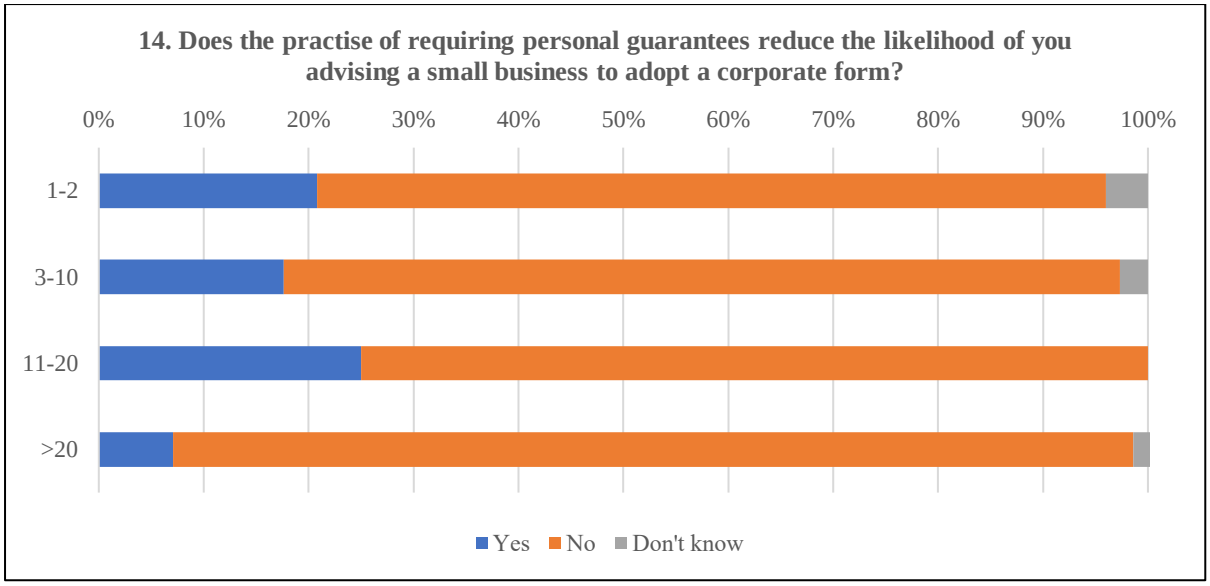
Figure 12: Relationship between the use of personal guarantees and likelihood of advising an owner-managed business to adopt a corporate form, by reference to experience



A significant gulf in opinion between respondents based in the largest firms (more than 20 accountants) and the remainder of the class is evident in the data – in the former category, just 7.1%[136] reported that the personal guarantee made them less likely to advise an owner-managed business to adopt a corporate form (Figure 13).

136 3/42.

Figure 13: Relationship between the use of personal guarantees and likelihood of advising an owner-managed business to adopt a corporate form, by reference to firm size



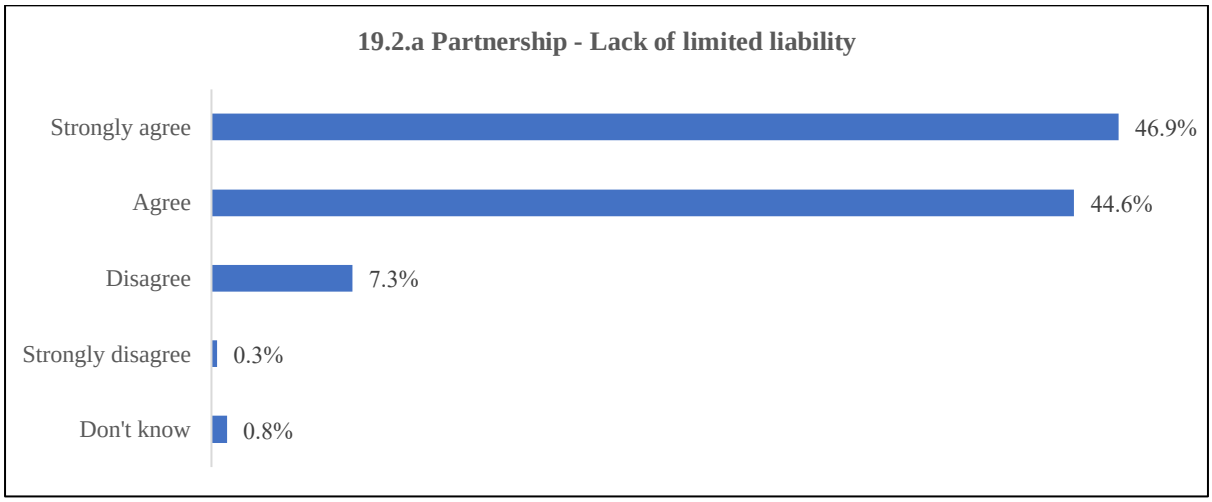
The overall position appears to be that whilst limited liability is almost universally agreed as the primary advantage of incorporation for owner-managed businesses (both in previous studies and that recently conducted by the author),[137] this simply does not hold for a significant proportion of owner-managers in practice. Strangely, this appears to be having a limited impact upon the advisory process of the surveyed accountants, though one respondent to the author's survey did comment: '*when you are asked to sign a PG [personal guarantee], irrespect [sic] for all lending, then limited liability is a mess... we should be eliminating the PG all together and use partnerships.*' Indeed, where limited liability is undermined by a personal guarantee, or for some other reason, the position of the company owner-manager in terms of personal liability is not dissimilar from the partner in a partnership.

137 Freedman and Godwin (n 32); HMRC Reasons Behind Incorporation (n 25); OTS Small Company Taxation Review (n 40).

2.2.1.4 Partnerships

When the potential disadvantages of operating in partnership were explored in the author's empirical research, lack of limited liability was overwhelmingly identified as the main downfall with 91.5%[138] of respondents agreeing that this is a disadvantage.

Figure 14: Agreement that limited liability is a disadvantage of the partnership



AAT (or equivalent) qualified accountants (15%)[139] and accountants in the smallest firms (13.6%)[140] were most likely to disagree that lack of limited liability is a partnership disadvantage, but they remain in the small minority even within those categories (Figures 15 and 16).[141]

138 324/354.

139 6/40.

140 17/125.

141 Cross-tabulated data for experience has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Figure 15: Agreement that limited liability is a disadvantage of the partnership, by reference to qualification

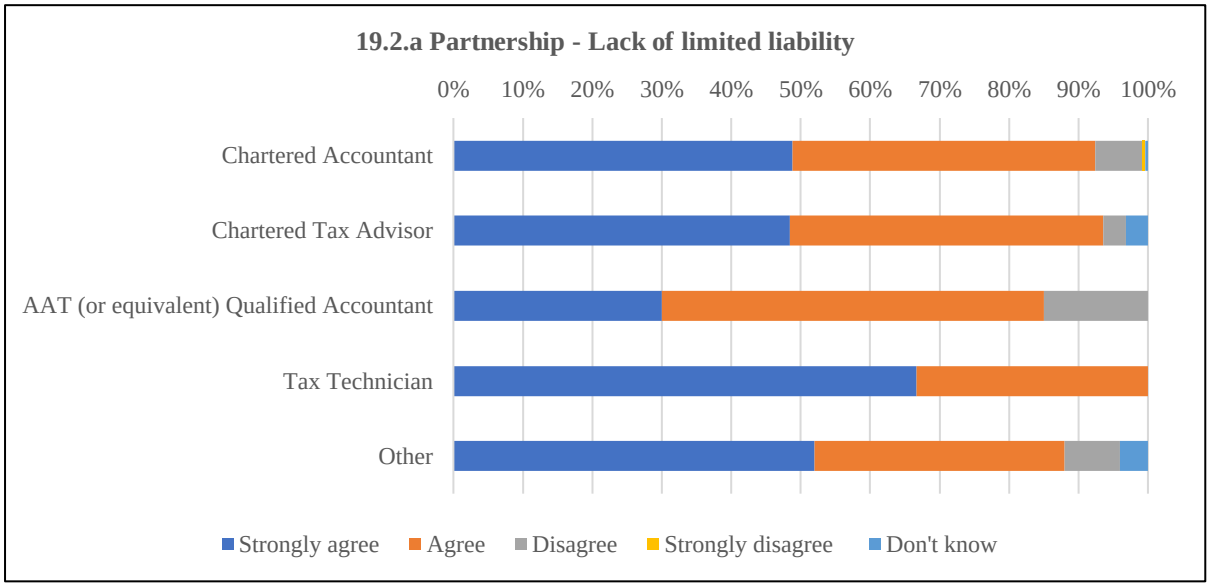
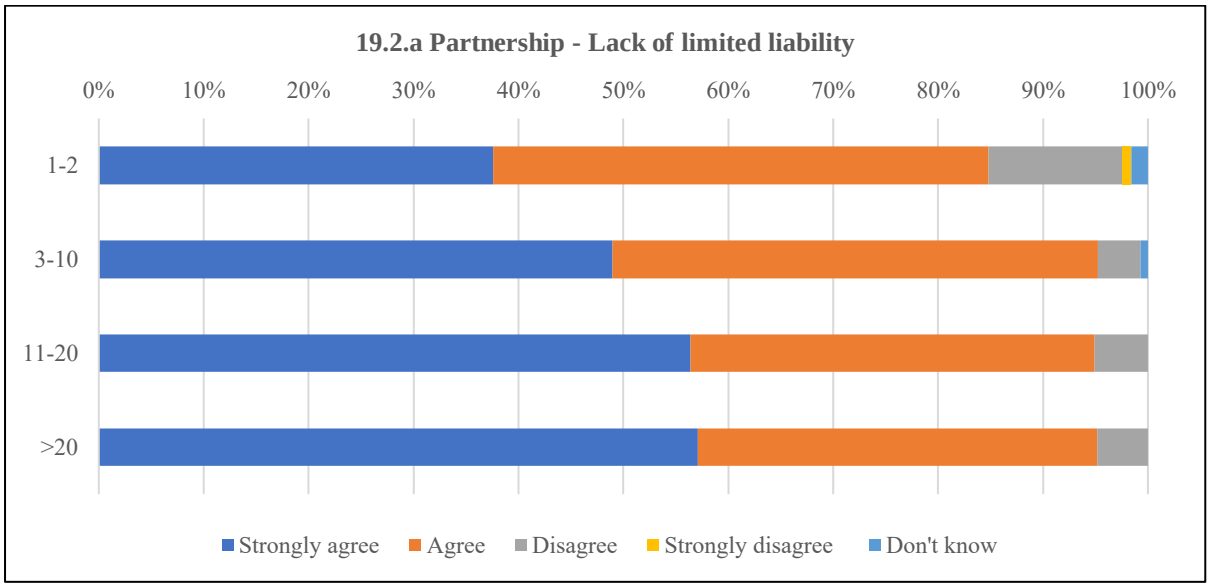


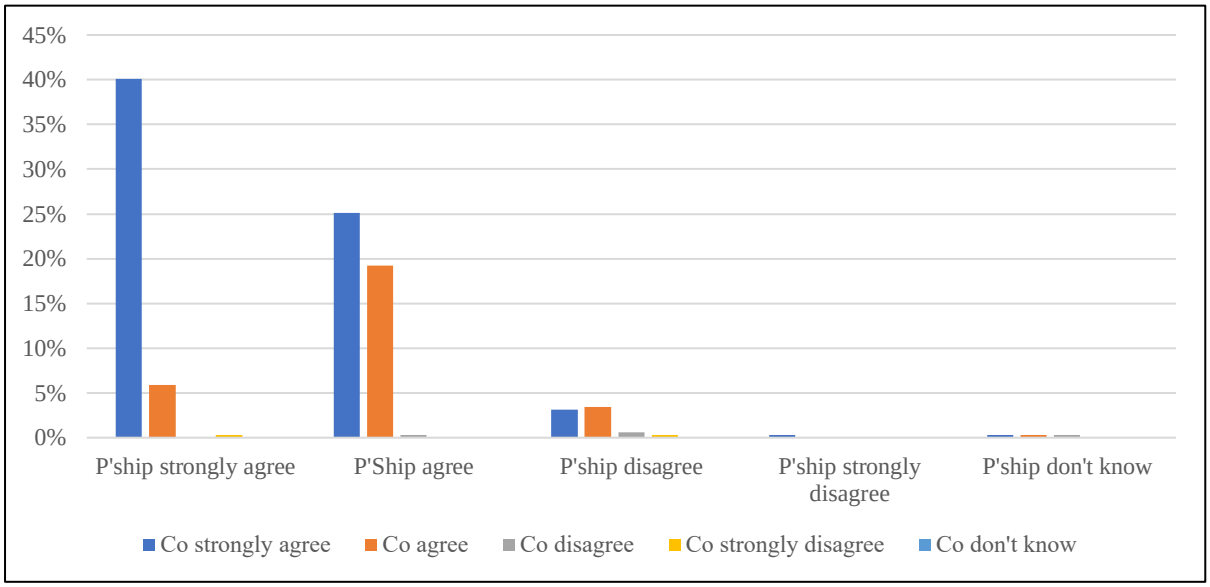
Figure 16: Agreement that limited liability is a disadvantage of the partnership, by reference to firm size



Cross-referencing the answers to both questions in relation to limited liability (companies and partnerships) demonstrates that broadly the accountants expressed a consistent

view on the limited liability issue – 90.3%[142] simultaneously agreed (to some extent) that limited liability was an advantage of the company form and that unlimited liability was a disadvantage of operating in partnership.

Figure 17: Agreement that limited liability is an advantage of the company and unlimited liability is a disadvantage of the partnership



The complete picture in relation to the pursuit of limited liability is undoubtedly a complex one. Limited liability continues to be cited as a (if not the) primary driver of the incorporation of owner-managed businesses and lack of limited liability is simultaneously viewed by the respondent accountants as the primary disadvantage of operating through a partnership, which is perfectly consistent. There is no doubt that some, perhaps even a significant number of, owner-managed businesses will retain the protection and benefits of limited liability. However, it also appears to be the case that limited liability is often surrendered as a matter of course by many owner-managers when accessing loans, engaging with significant trade creditors, or renting business premises. Accountants appear to be

142 322/354.

cognisant of this, but unfazed, which ought to lead to caution in accepting the rationale that the pursuit of limited liability is a good reason for the incorporation of an owner-managed business. At the very least, it should generate a concern that at least some owner-managers are highly likely to be incorporating under false pretences, whether advised by an accountant or otherwise. It is important to note that the attraction of limited liability would also be a draw for those operating as sole traders, but as demonstrated in Chapter 1, the number of sole traders has not declined in the same way as ordinary partnerships thereby suggesting there is more than just limited liability in play. Of course, it is possible that there are other reasons that can explain, or contribute to the understanding of, the propensity of owner-managed businesses to incorporate and abandon the ordinary partnership. The remainder of the thesis, up to and including Chapter 4, explores those alternate reasons.[143]

2.2.2 Separate Legal Personality[144]

'The separate corporate personality doctrine is what underpins much of the company's success as an effective business structure.'[145] Closely linked to limited liability, it aids in the separation of business activity from personal obligations, the segregation of assets, and ensures business continuity through changes in ownership which can be helpful for succession planning with owner-managed businesses. Yet, durability of the business form is not necessarily desirable for all owner-managed businesses 'because it can help controlling owners and managers treat locked-in owners opportunistically.'[146] This may be a particular concern in the event of a

143 Chapter 5 focuses upon reforming the law in relation to disincorporation.

144 Armour (n 45): 'Starting from the premise that the company is itself a person, in the eyes of the law, it is straightforward to deduce that it should be capable of entering into contracts and owning its own property; capable of delegating authority to agents; and capable of suing and being sued in its own name.'

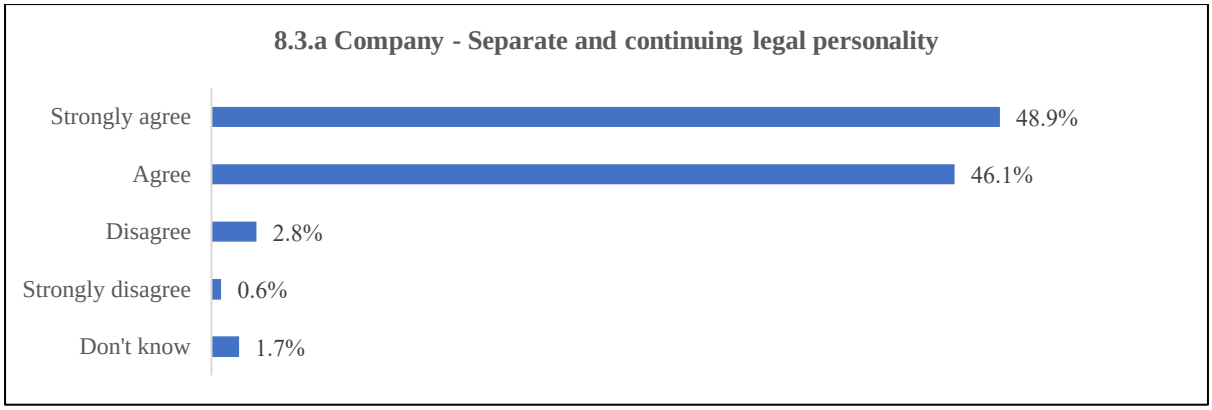
145 Gower (n 30) 36.

146 Larry Ribstein, *The Rise of the Uncorporation* (OUP 2009) 97.

relationship breakdown between the owner-managers.[147] Accordingly, closely held firms must balance the costs of allowing owners to leave against those of forcing them to stay.[148]

The empirical research confirmed that accountants agreed that separate and continuing legal personality is indeed a company advantage. 48.9%[149] strongly agreed with the statement and a further 46.1%[150] agreed (a total of 95%).[151]

Figure 18: Agreement that separate legal personality is an advantage of the company[152]



If cross-tabulated with views upon limited liability, it can be seen in Figure 19 that 42.2%[153] of the respondents strongly agreed that both limited liability and separate legal

147 In the US, the fate of a co-owned business following a divorce is quite often determined by pre-nuptial agreements. See: Benjamin Means, 'Contractual Freedoms and Family Business' in Robert Hilman and Mark Loewenstein, *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations* (Edward Elgar Publishing 2015).

148 ibid.

149 176/360.

150 166/360.

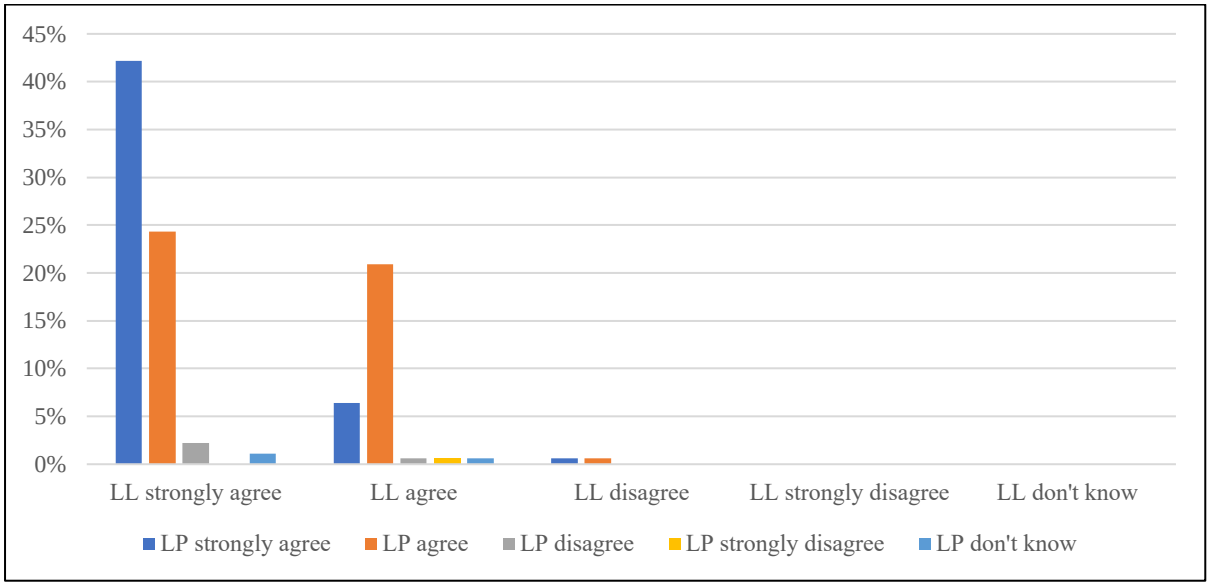
151 342/360.

152 Cross-tabulated data for qualifications, experience and size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

153 151/358.

personality are advantages, whilst 93.8%[154] agreed that, to some extent, both limited liability and separate legal personality were advantages of the company form. This result is not surprising considering the previous observations.

Figure 19: Agreement that both limited liability and separate legal personality are advantages of the company[155]



However, just as with limited liability, the benefit of separate legal personality is not unassailable, though the circumstances in which separate legal personality is disregarded are more infrequent than the operation of the personal guarantee. The decision in *Salomon's* case[156] treats the legal independence of the company as sacrosanct, but there are nonetheless instances (usually involving questions of control) where the corporate veil is pierced.[157] This is most

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154 336/358.

155 Abbreviations: LL = limited liability; LP = legal personality.

156 *Salomon v Salomon & Co Ltd* [1897] AC 22.

157 See Palmer's (n 56) 2.1533. One accountant's response indicated that a key disadvantage of operating through a company today was the '*increasing removal of the corporate veil*.'

likely to affect owner-managers where the court is preparing to order the winding up of a company under the 'just and equitable' clause[158] i.e. section 122(1)(g) IA 1986.[159] This ought not to be of concern to the majority of owner-managers and is certainly unlikely to be a factor in the decision to incorporate, but this note is just a further one of caution that all is not as ideal as it may initially seem when it comes to the supposed advantages of incorporation.

The surveyed accountants were also asked for their views upon whether the lack of legal personality for partnerships is a disadvantage of operating through the form.[160] As expected, and corresponding with the views upon company advantages, the majority agreed that this was the case (74%).[161] On the other hand, it is noteworthy that a significant proportion

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158 The power has existed unaltered in statutory form since the Companies Act 1862.

See *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360 at 375, 379 per Lord Wilberforce: 'The same words "just and equitable" appear in the Partnership Act 1892, section 25, as a ground for dissolution of a partnership…the importance of this is to provide a bridge between cases under section 222(f) Companies Act 1948 [the predecessor to section 122(1)(g) IA 1986] and the principles of equity developed in relation to partnerships…the words are a recognition of the fact that a limited company is more than a mere judicial entity, with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.'

159 Palmer's (n 56) 2.204: 'Private companies, which are in substance partnerships though carried on in the legal form of a company, are colloquially referred to as *quasi-partnership companies* and their substantive character is sometimes taken into account by the courts, particularly when deciding issues pertaining to the protection of minorities, unfairly prejudicial treatment (s.994), or a petition for the winding up of the company on the "just and equitable" ground (IA 1986 s.122(1)(g)).'

It is less likely that the 'evasion principle' would be applicable in such instances, given the notions of deliberate avoidance methods, though it is a situation in which the corporate veil will be pierced. In any event, the scope of the *Prest v Petrodel Resources Ltd* [2013] UKSC 34 'evasion principle' seems to have been significantly curtailed by the decision in *Hurstwood Properties (A) Ltd and others v Rossendale Borough Council and another* [2021] UKSC 16.

160 Roderick l'Anson Banks and Nathaniel Lindley, *Lindley & Banks on Partnership* (16th edn, Sweet & Maxwell 1990) 26-05, quoting a comment in an earlier edition: 'The position of the executors of a deceased partner is, in fact, often one of considerable hardship and difficulty; if they insist on an immediate winding up of the firm, they may ruin those whom the deceased may have been most anxious to benefit; whilst if for their advantage the partnership is allowed to go on, the executors may run the risk of being ruined themselves.'

161 Scottish responses are excluded in the calculation of the figures in this section because Scottish partnerships do have legal personality. However, 66.67% (4/6) did agree with the statement perhaps indicating that the respondents read the question as related to English partnerships. One respondent noted in free text that the question did not apply in Scotland.

disagreed with the proposition that lack of legal personality is a disadvantage (23.9%),[162] but only one respondent did so strongly. This might be taken as indicating that owner-managed businesses can sensibly operate as partnerships without encountering insurmountable difficulties with the lack of legal personality. Indeed, for tax purposes, 'the business carried on by a partnership is regarded as continuous, despite a change in the members of the partnership, provided there's at least one partner who is a member of both sides of the change.'[163] The partnership agreement can also make provision for the consequences of a change in membership, though this does not alter the strict legal position that there will be a cessation of the existing partnership.[164]

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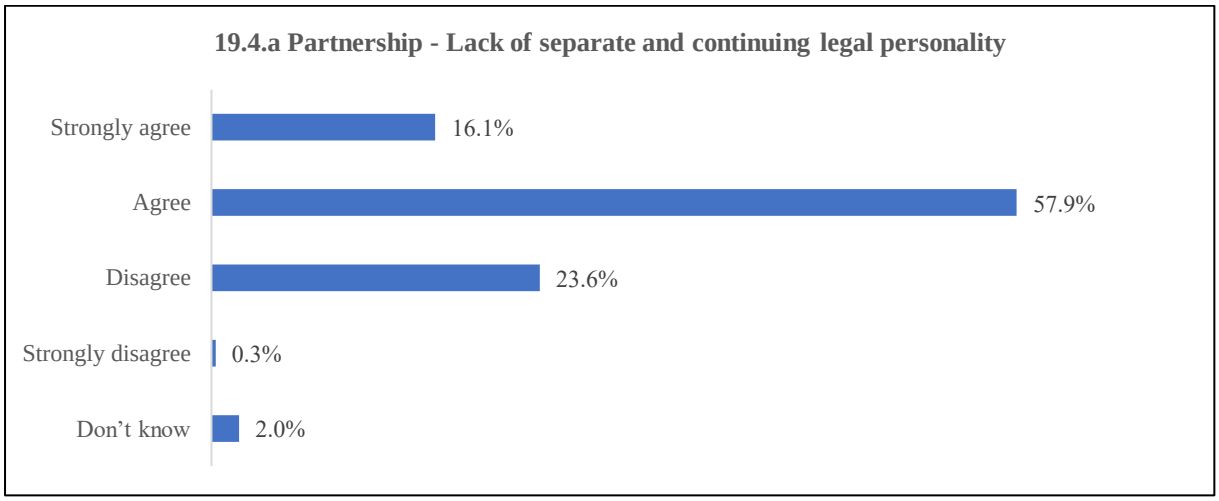
162 83/347.

163 HM Revenue & Customs, *Partnership Tax Return Guide* <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/974213/SA850-Notes-2021.pdf> accessed 3 April 2022. For VAT purposes, the partnership is automatically treated as a separate entity under Value Added Tax Act 1994 ("**VATA 1994**"), s 45.

164 Roderick l'Anson Banks, *Lindley & Banks on Partnership* (20th edn, Sweet & Maxwell 2020) 3-05 discusses the possibility that partners may agree that a change in membership will not affect the continuation of the partnership but takes the view that this will not alter the legal analysis. The OTS has suggested that this is an area that should be covered in a partnership agreement for any small trading partnership: Office of Tax Simplification, *Review of Partnerships: Final Report*, January 2015, 41 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/396668/ots_partnerships_report_final.pdf> accessed 3 April 2022. The Law Commission & Scottish Law Commission, *Partnership Law, A Joint Consultation Paper* (Law Commission No 283; Scottish Law Commission No 192) 8.30 also recommended that, in addition to legal personality the partnership should be regarded as continuing where two or more partners remained, which would align partnership law with the approach adopted by HMRC.

Figure 20: Agreement that lack of separate legal personality is a disadvantage of the partnership[165]



Cross-tabulation of the results by reference to qualifications (Figure 21) and firm size (Figure 22) demonstrates a diversity of opinion across the groups. However, the only clear trend is in relation to firm size, where it transpires that the smallest accountancy firms were much more likely to disagree with the proposition that lack of legal personality is a disadvantage of operating as a partnership when compared to their larger counterparts. 34.1%[166] of the accountants in a firm size of 1-2 disagreed, as compared to just 15.8%[167] in the 11-20 category and 15%[168] in firms with more than 20 accountants.[169]

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165 Cross-tabulated data for experience has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

166 42/123. Though these firms are the least likely to have advised an owner-managed business to form an ordinary partnership.

167 6/38.

168 6/40.

169 The 3-10 category recorded the only 'strongly disagree' response.

Figure 21: Agreement that lack of separate legal personality is a disadvantage of the partnership, by reference to qualification

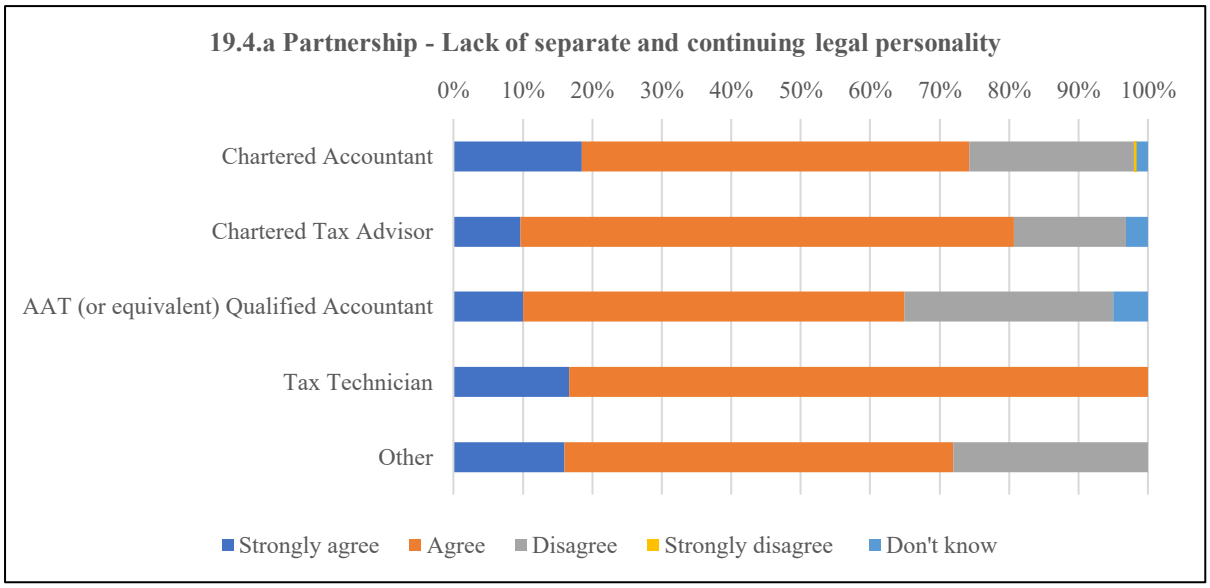
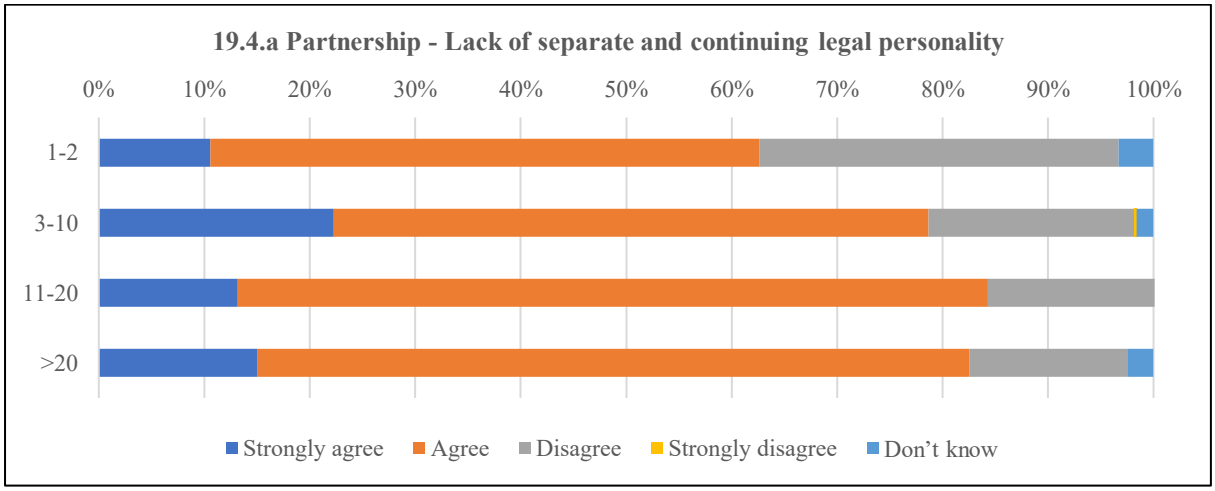


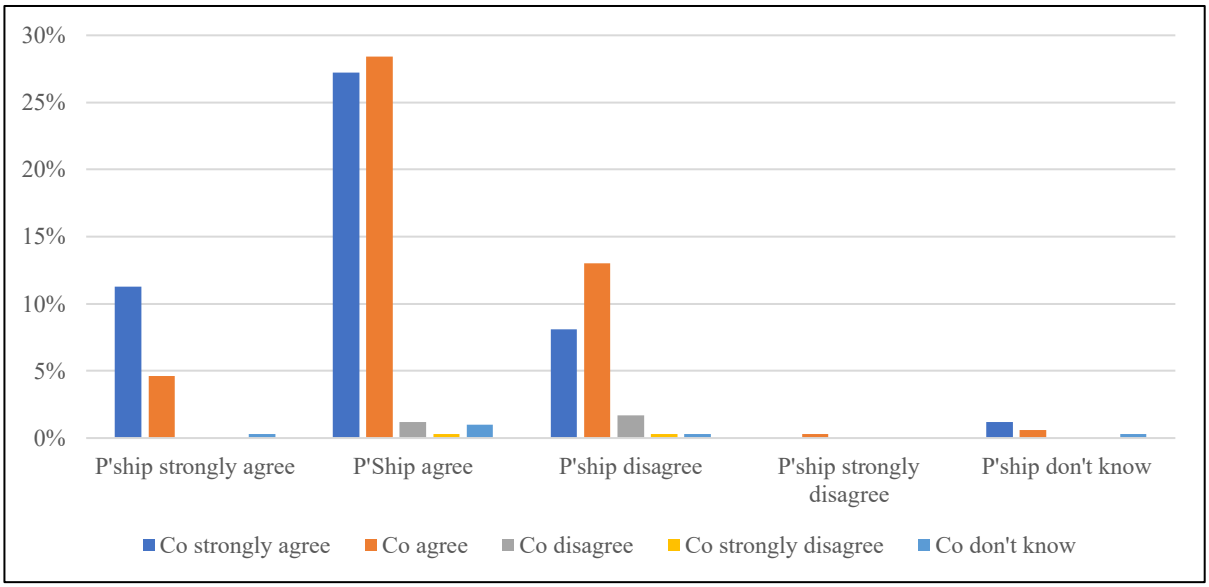
Figure 22: Agreement that lack of separate legal personality is a disadvantage of the partnership, by reference to firm size



If the responses in relation to both questions on legal personality (companies and partnerships) are cross-referenced then, as expected, it appears that most of the respondents

agreed (at least to some extent – 71.5%)[170] that the presence of legal personality is an advantage of the company form, and the lack thereof is a disadvantage of operating in partnership. However, there is a notable proportion of individuals (13.3%)[171] whose responses did not correspond in this fashion, believing that lack of legal personality was not necessarily a disadvantage of the partnership form, but nonetheless an advantage of operating as a company.

Figure 23: Agreement that separate legal personality is an advantage of the company and that lack of separate legal personality is a disadvantage of the partnership [172]



2.2.3 Enhanced Credibility

Enhanced credibility was the second cited 'main advantage' of incorporation in the OTS Small Company Taxation Review. Likewise, the results of Freedman and Godwin's study presented

170 247/345.

171 45/345.

172 See (n 161).

prestige and credibility as the second most prominent reason for incorporation.[173] Freedman & Godwin also explored the attitudes to companies with small business owners, and 'around half believed that banks (52 per cent), suppliers (52.1 per cent) and customers (48 per cent) preferred to do business with incorporated businesses.'[174] In fact, according to the OTS report more respondents 'strongly agreed' that enhanced credibility influenced their decision to form a limited company than limited liability.[175] 13% of the respondents to the quantitative element of the HMRC Reasons Behind Incorporation study cited improved reputation or credibility as a reason for deciding to incorporate without prompting: this figure increased to 74% after prompting.[176] When this response was unprompted, it was just the fourth most popular reason for incorporation after limited liability, tax advantages and the need to satisfy customer requirements but became second highest after prompting.[177] The qualitative findings of the HMRC Reasons Behind Incorporation study support the overall view that enhanced credibility has a significant impact upon the decision to incorporate - one respondent claimed that 'it made the company look more credible in the eyes of consumers or potential contractors (as a

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173 Freedman and Godwin (n 32) 247. This amounted to 50.4% of the responses, as compared to 53.6% citing limited liability.

174 Freedman and Godwin (n 32) 247: 'The obligation to disclose information on the Companies Register may account for some of the confidence shown in incorporated firms – although only 4.8 per cent of respondent companies often made use of the accounts of other companies filed at Companies House. The simple fact of registration, and consequent increased visibility may also help. However, the real explanation may be linked with the fact that the bigger the firm, the more likely it is to be incorporated. Overall, this may lead to the impression that a company is more reliable than an unincorporated firm. Given the large number of very small companies with little or no capital…this is clearly not a valid universal assumption. Incorporation is not an indicator of size or standing.'

175 OTS Small Company Taxation Review (n 40) 8, Chart 1.A, though it is unclear how this fits with the HMRC Reasons Behind Incorporation data (n 25) 30, since this Report suggests that 52% strongly agreed in relation to limited liability and only 47% strongly agreed that improved reputation/credibility was an important consideration in the decision to incorporate.

176 HMRC Reasons Behind Incorporation (n 25) 27, 30. After limited liability, tax advantages and the need to incorporate as a requirement for certain contracts.

177 HMRC Reasons Behind Incorporation (n 25) 30. Though more respondents still 'strongly agreed' (52%) that limited liability was an important factor in the decision to incorporate than enhanced credibility (47%).

"business" rather than just a "named person")' and there were further comments to similar affect.[178] 38% of the respondents had also received the advice that incorporation would improve the reputation of the business (25% paid for advice, 10% free advice).[179] The study also reported that enhanced credibility was seen as the main benefit of the company form three years *after* incorporation.[180]

The author's empirical research found that whilst a high proportion of respondents agreed (84.9%)[181] that enhanced credibility (or prestige) was an advantage of incorporation, it only came seventh out of the nine advantages offered as part of the survey.[182] When compared to the OTS and HMRC Reasons Behind Incorporation Reports, it can be seen that whilst a higher overall percentage of accountants in this study than business owners in previous studies believe that enhanced credibility is an advantage of incorporation it appears that this may fall further down the list of priorities for accountants in their advisory process than it does for individuals in their decision to incorporate. It is also noteworthy that the HMRC Reasons Behind Incorporation respondents needed prompting for the reason to become predominant alongside limited liability.

178 HMRC Reasons Behind Incorporation (n 25) 33, 34, 54: 'It's all a big game, credibility, your customers think "oh-they must be good they're a limited company", rather than Joe Bloggs. If you have on your letter head "Limited" then it does give a certain comfort…to the customers as well.'

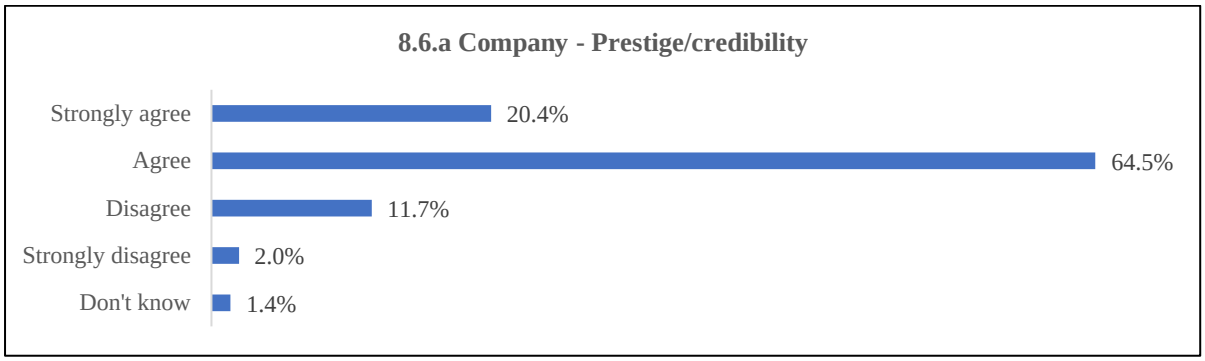
179 HMRC Reasons Behind Incorporation (n 25) 24.

180 HMRC Reasons Behind Incorporation (n 25) 3, 50, 51. 22% of unprompted responses.

181 304/358.

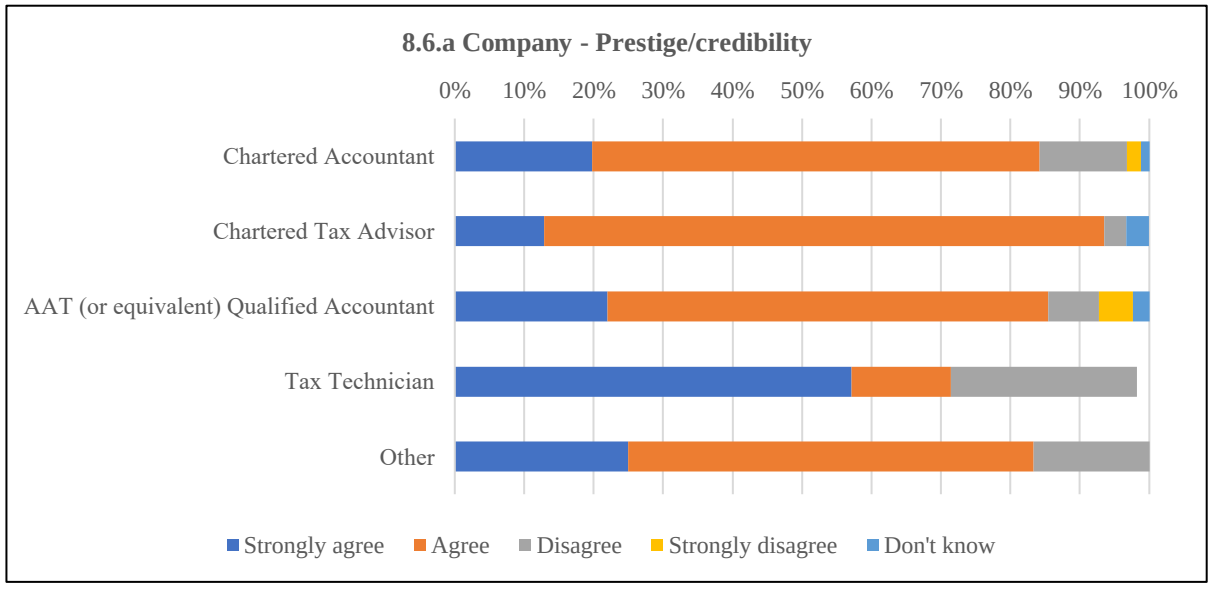
182 One respondent strongly disagreed with the proposition, commenting: 'the prestige of a limited company is a falsehood…The British and Anglo Saxon model of profit and capital gains drives incorporation root and the false prestige'.

Figure 24: Agreement that enhanced credibility is an advantage of the company[183]



Chartered Tax Advisors (93.5%)[184] and AAT (or equivalent) qualified accountants (85.4%)[185] were noticeably more likely to agree that prestige and credibility is an advantage of the company form than their counterparts (Figure 25).

Figure 25: Agreement that enhanced credibility is an advantage of the company, by reference to qualification



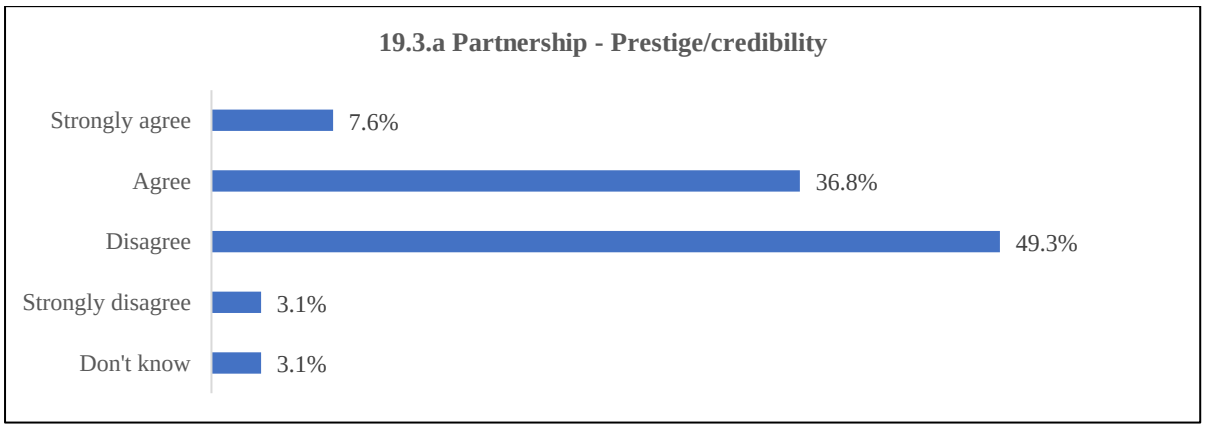
183 Cross-tabulated data for experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

184 29/31.

185 35/41.

The author's survey further explored whether the respondents were of the view that there was a corresponding disadvantage with the partnership i.e. whether they agreed that partnerships lacked prestige/credibility. Whilst perhaps not overwhelming, the majority (52.4%)[186] of respondents reported *disagreement* with the suggestion that partnerships lacked credibility as a business form.

Figure 26: Agreement that lack of prestige/credibility is a disadvantage of the partnership



A wide range of opinion as the prestige and credibility of partnerships appears if the responses are separated based on respondent qualification level (Figure 27) and firm size (Figure 29), though without any correlation. Another notable outlier was detected based on respondent experience – only 27.6%[187] of those in practice for 6-10 years disagreed that the partnership lacked credibility. This was offset by the 65%[188] of accountants in the 1-5 years' experience category (Figure 28).

186 185/353.

187 8/29.

188 13/20.

Figure 27: Agreement that lack of prestige/credibility is a disadvantage of the partnership, by reference to qualification

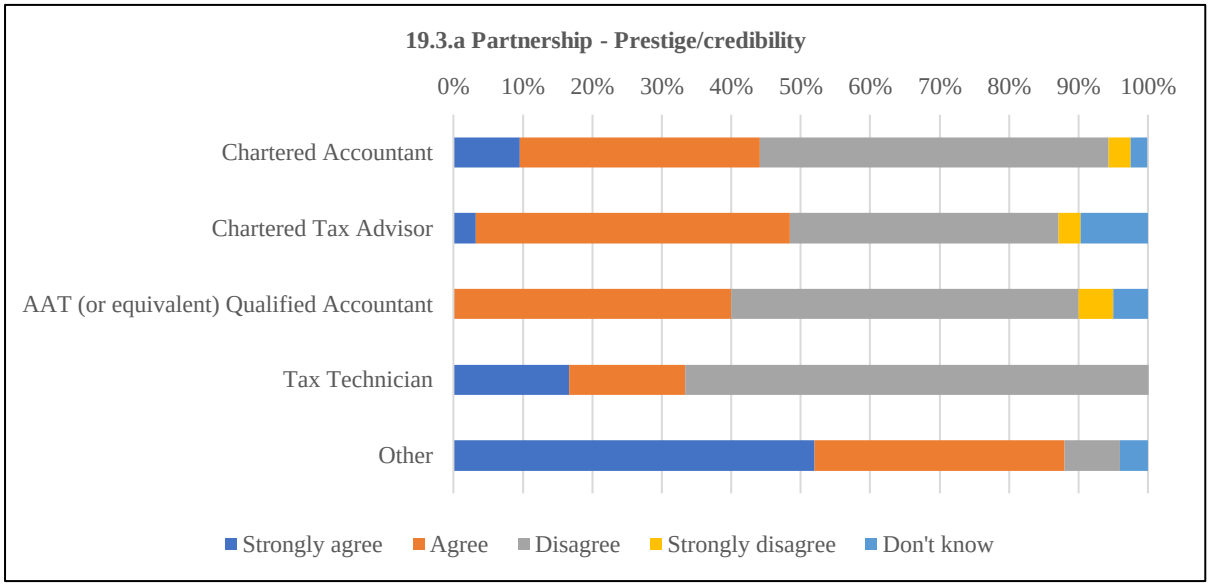


Figure 28: Agreement that lack of prestige/credibility is a disadvantage of the partnership, by reference to experience

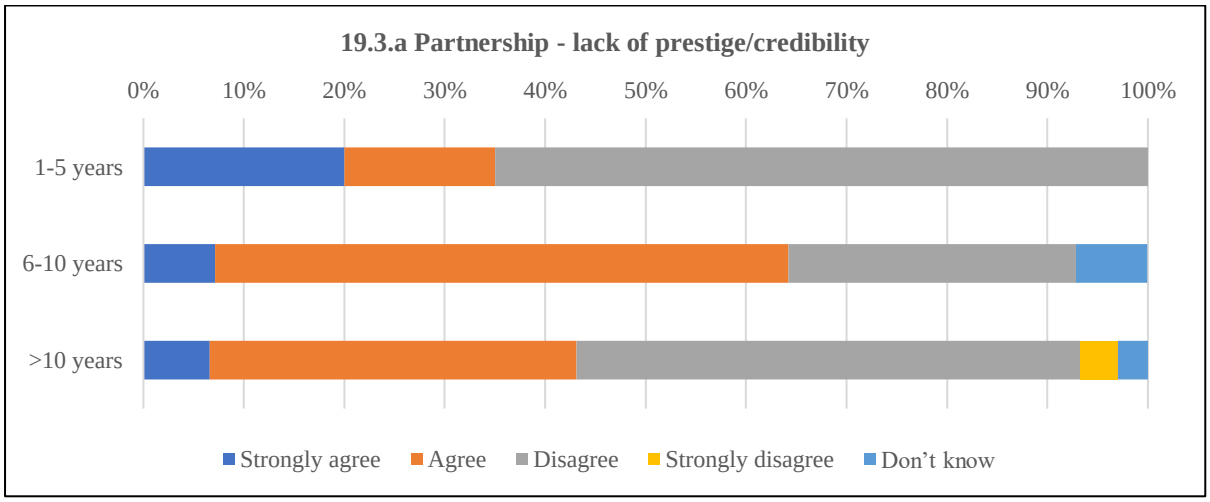
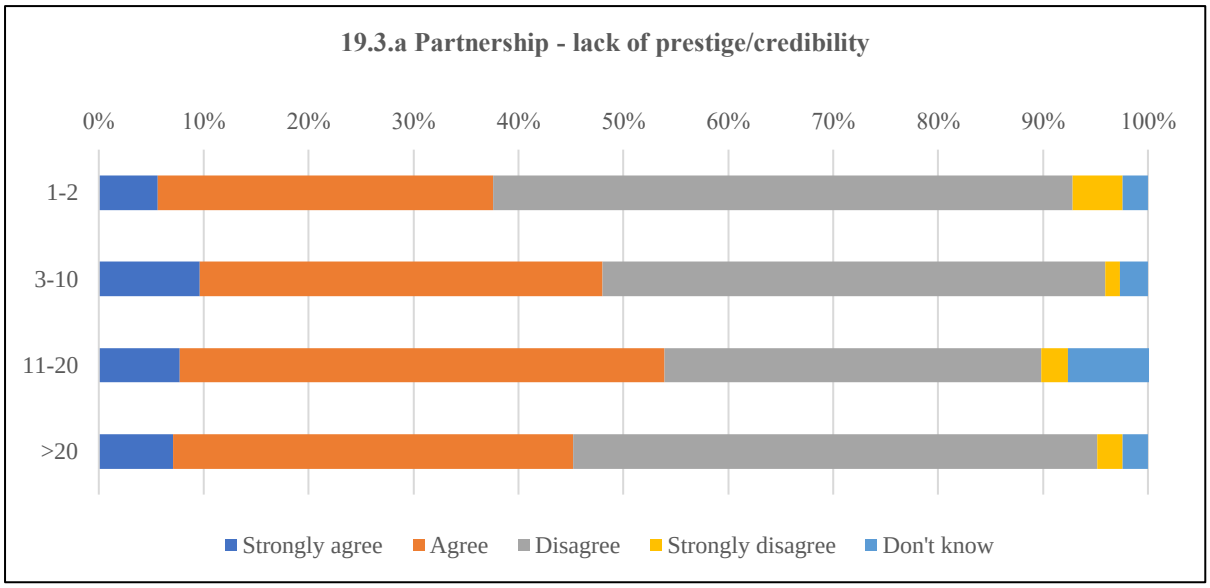


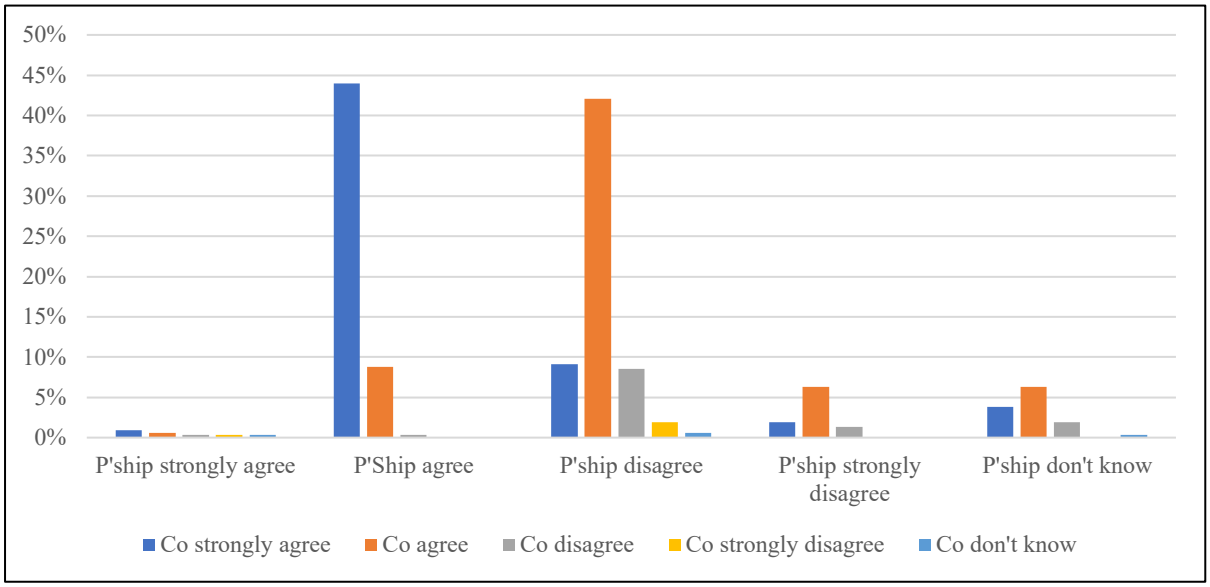
Figure 29: Agreement that lack of prestige/credibility is a disadvantage of the partnership, by reference to firm size



The picture is somewhat more complicated if the responses to the questions in relation to companies and partnerships on this point are pieced together because it appears that 59.4%[189] of the respondents who (to some extent) agreed with the proposition that enhanced prestige/credibility was a benefit of the company form also believed that the partnership did not lack such credibility as a form.

[189] 189/318.

Figure 30: Agreement that enhanced credibility is an advantage of the company and that lack of prestige/credibility is a disadvantage of the partnership



Overall, whilst enhanced credibility is a valid commercial reason for operating through a company form that appears to be influencing the decision of owner-managers to incorporate, either independently or under the advice of an accountant, it does not seem to be capable of accounting for the choice of a company over and above a partnership form for owner-managed businesses. The author's empirical research highlights this by indicating that respondents did not generally believe that there was a corresponding lack of credibility associated with partnerships. It is possible that the enhanced credibility that supposedly comes with incorporation is more likely to be a benefit encountered as a 'pleasant surprise' after incorporation, rather than being a significant cause of incorporation, or reason for choosing a company over a partnership - a point also noted in the HMRC Reasons Behind Incorporation report.[190]

190 See HMRC Reasons Behind Incorporation (n 25) 54.

2.2.4 Formal Business Structure

As noted above, the provision of a formal business structure was the third 'main advantage' of incorporation noted by the OTS Small Company Taxation Review.[191] The formal business structure rationale for incorporation is often associated with enhanced credibility, owing to the perception that the former facilitates the latter. Indeed, the HMRC Reasons Behind Incorporation study combines the two reasons as a single broad category in the explanation of its findings;[192] but they are again treated separately by the OTS in the Small Company Taxation Review.[193] 12% of respondents to the HMRC Reasons Behind Incorporation study, before prompting, cited the provision of a formal structure as a reason for incorporation (the fifth most popular reason), increasing to 70% (third most popular reason) after prompting.[194] The implication of the report is that, although the difference is minor, enhanced credibility is prioritised over the formal business structure.

Interestingly, the author's surveyed accountants were significantly more likely to agree that a formal business structure is an advantage of the company form (ranked fourth out of nine – 91.3%)[195] than enhanced credibility (seventh out of nine – 84.9%).[196] The percentage of accountants strongly agreeing that formal business structure (30.2%)[197] was also 22.3% higher than with enhanced credibility. In this respect, another difference between the author's

191 (n 40).

192 HMRC Reasons Behind Incorporation (n 25) 31, 33

193 (n 40) 115.

194 HMRC Reasons Behind Incorporation (n 25) 28, 30.

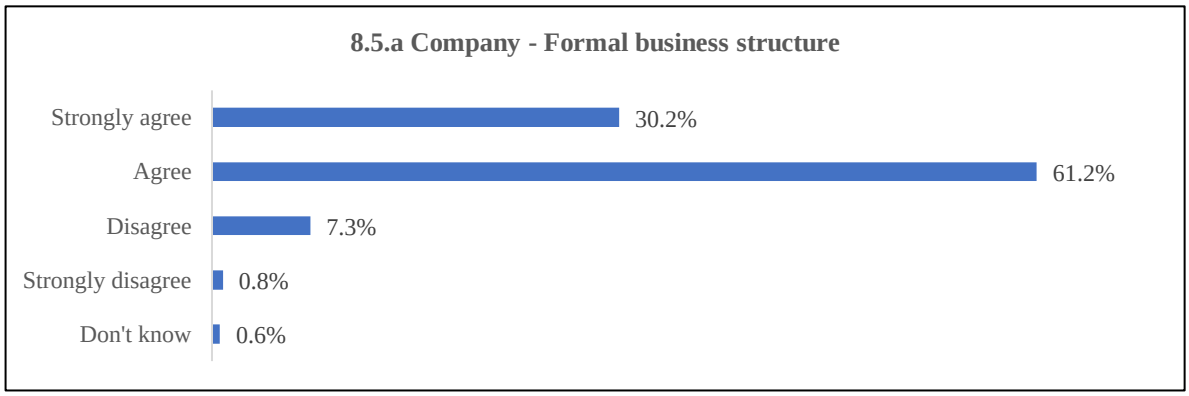
195 327/358.

196 304/358.

197 108/358.

respondents and the owner-managers surveyed as part of the HMRC Reasons Behind Incorporation report emerges. There are two different inferences that could be drawn here. Firstly, it could be the case that accountants are more likely to view enhanced credibility as a consequence of the beneficial formal structure and thereby less of a feature in the decision to incorporate. This somewhat accords with the HMRC Reasons Behind Incorporation findings that business owners were more willing to say that enhanced credibility was a benefit *after* incorporation, as compared to before. Secondly, it might be that exposure to the operation of multiple business forms has led accountants to believe that the company does not attract a significantly higher degree of credibility than any other form.

Figure 31: Agreement that formal business structure is an advantage of the company[198]

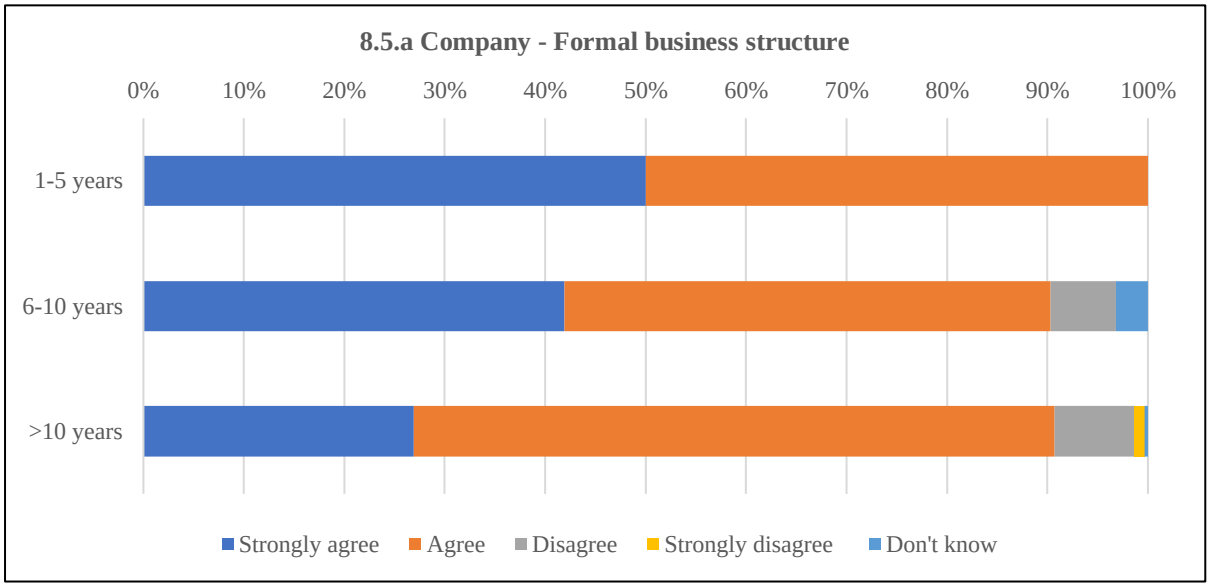


All respondents (100%)[199] that had been advising for 1-5 years agreed that the formality of the company business structure was an advantage of the form (Figure 32).

198 Cross-tabulated data for qualification and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

199 22/22.

Figure 32: Agreement that formal business structure is an advantage of the company, by reference to experience



The author's survey did not include a provision to identify whether the respondents believed that there was a corresponding disadvantage with the partnership form. However, the survey did question whether the flexible business structure of a partnership was an advantage of the form, with which the majority of respondents agreed (75.9%) – this is explored further in Part 2.3.4 below. This flexibility inherent in the partnership form allows partners to make the business arrangement as formal or informal as they wish, meaning that the partners could, if they chose to do so, structure the partnership agreement in a manner with an equivalent level of formality as the typical company articles of association.

2.2.5 Satisfying Customer Requirements

Whilst the aforementioned are often considered the primary advantages of incorporation, there are no doubt other sound economic reasons that may lead an owner-managed business to

choose to incorporate. Any customer requirements would need to be a key consideration – if the business is dependent upon concluding contracts which require incorporation, then incorporation must be regarded as critical and a partnership is not a viable business form. Referring to the HMRC Reasons Behind Incorporation study once more, 37% of the respondents (29% of which had received paid advice, 9% unpaid advice) had been advised that incorporation would help to meet required criteria to be a supplier on certain contracts[200] and 15% thereby gave such a reason, without prompting, as a 'main reason' for deciding to incorporate.[201] This ranked as the third highest unprompted reason for incorporation (15%),[202] and also third in the list of incorporation considerations with which individuals reported 'strong agreement' that it had affected the decision to incorporate (38%).[203] Overall, it ranked fifth in the list of important considerations (60% agreeing),[204] and was subsequently cited as the fourth main benefit of incorporation after the event (14% unprompted).[205] 25% of the HMRC Reasons Behind Incorporation respondents that had agreed that satisfying customer requirements was one of the main benefits of incorporation indicated that they had in fact been awarded contracts for which being incorporated was part of the criteria, though 48% of them had been awarded just one or two contracts with that requirement.[206] The Report also notes that:

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200 HMRC Reasons Behind Incorporation (n 25) 24. Office of Tax Simplification, *Small Business Tax Review: Final Report, Disincorporation Relief,* February 2012 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/199181/03_ots_small_business_tax_review_disincorporation_280212.pdf> accessed 3 April 2022, 19 notes that many agency and contractor workers have been obliged to operate through limited companies.

201 HMRC Reasons Behind Incorporation (n 25) 27.

202 After limited liability (24%) and tax and national insurance savings (19%); HMRC Reasons Behind Incorporation (n 25) 28.

203 After limited liability and improved reputation/credibility for company; HMRC Reasons Behind Incorporation (n 25) 30.

204 HMRC Reasons Behind Incorporation (n 25) 30.

205 HMRC Reasons Behind Incorporation (n 25) 51.

206 HMRC Reasons Behind Incorporation (n 25) 55.

> [c]ompanies in certain sectors were more likely to have been awarded contracts for which being incorporated was part of the criteria: professional, scientific or technical (33%) and administrative or support services (33%). This was also more common among businesses without any employees (31%) and among respondents whose previous employer was now a client.[207]

This is consistent with the general consensus that a substantial number of customers in the above sectors are likely to engage personal service companies, that have often set up by former employees.[208] The rationale for making contracts conditional upon company status appears to be to try and ensure that the 'customers' themselves are insulated from the risk that employment and taxation law will impose additional obligations upon them – the company offers an extra degree of separation in this respect, though the taxation position has been affected by the ever changing IR35 rules.[209] Such contracts can often make or break the business for individuals,[210] though the overall value of the contracts varies significantly: 'in 16% of cases, the value was less than £10,000, but 26% said that the total value was £100,000 or more'.[211] It is highly unlikely that any respondent needing to incorporate in order to obtain contracts would regard the partnership as a viable form, but it is worth noting that only 3.5% of those surveyed reported that they were specifically required to do so for the award of contracts.[212]

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207 HMRC Reasons Behind Incorporation (n 25) 55.

208 OTS Small Company Taxation Review (n 40) 10. These are also more likely to involve one owner-manager, so a partnership would not be viable in any event. One respondent to the author's survey indicated that some government contracts also required limited liability status.

209 Income Tax (Earnings and Pensions) Act 2003 ("**ITEPA 2003**"), Part 2, Chapter 8.

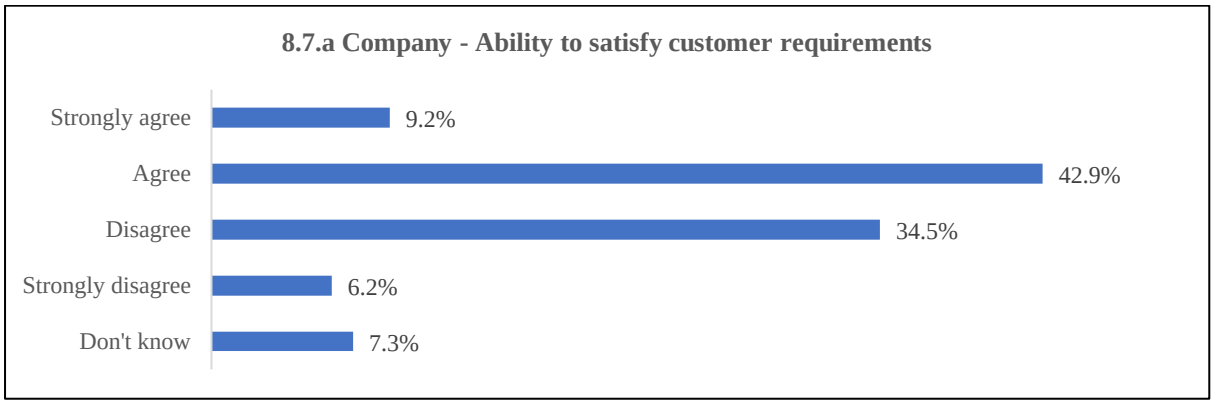
210 HMRC Reasons Behind Incorporation (n 25) 56.

211 HMRC Reasons Behind Incorporation (n 25) 56.

212 Amounting to 25% of the 14% of respondents that had said that securing such contracts was a main benefit of incorporation.

By way of comparison, the author's empirical research demonstrates that, from the accountancy perspective, the 'customer requirements' element of incorporation is significantly less important than the other proposed factors. Just 52.1%[213] of the accountants agreed that this was an advantage of incorporation for owner-managed businesses, though it is worth noting that in the free text responses 4 out of 53 mentioned, in some form of expression, that customer/tendering requirements were significant. Also worthy of comment is the high percentage of accountants selecting 'don't know' as a response to this question.

Figure 33: Agreement that ability to satisfy customer requirements is an advantage of the company[214]



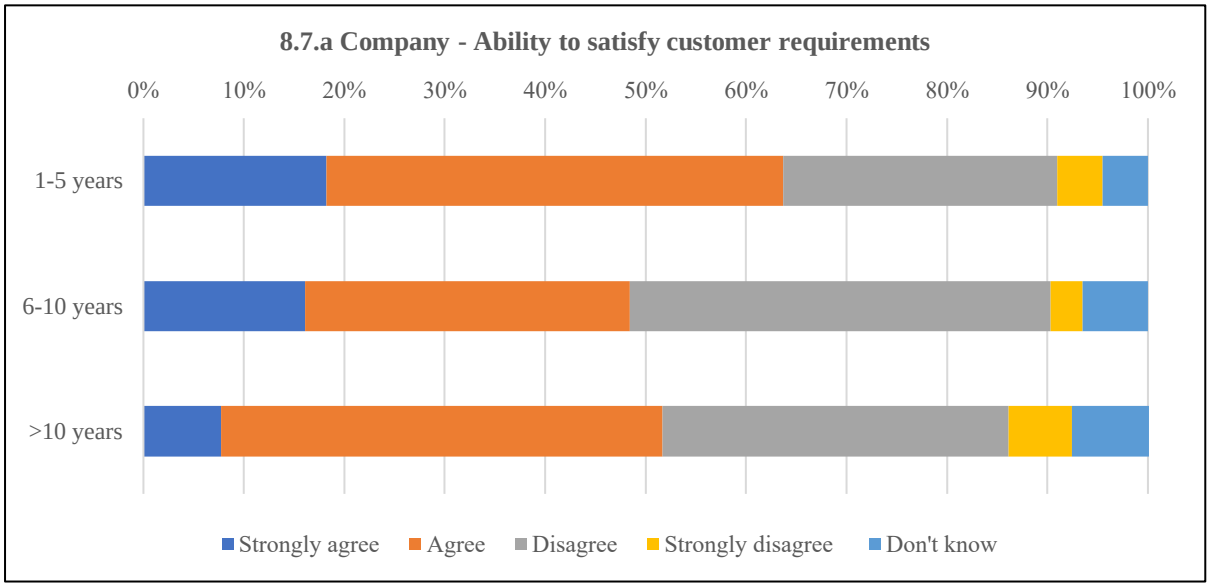
In relation to this matter, respondents that had been advising for the least amount of time were most likely to view the possible satisfaction of customer requirements as an advantage of the company form (63.7%).[215]

213 186/357.

214 Cross-tabulated data for qualification and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

215 14/22.

Figure 34: Agreement that ability to satisfy customer requirements is an advantage of the company, by reference to experience



Two reasons might be offered as to why customer requirements are significantly lower on the list of deemed advantages for accountants. Firstly, as compared to the business owner, accountants will no doubt encounter a broader spectrum of owner-managed businesses. That being the case, their exposure to business variety means that they will have engaged with business owners that operate outside of the sectors that typically demand corporate status for the award of contracts. Quite sensibly, the owner-manager will be focused on the one (or perhaps few) business(es) that they operate. Where that business operates in a sector that often depends upon the award of contracts tied to corporate status then of course that will feature highly on the list of priority and benefits associated with incorporation for the owner-manager, but there is no reason for that view to be reflected by an accountant who is not focused in the same way. Secondly, it would be a rare case for the accountant to be involved in the negotiation and conclusion of such contracts, leaving open the possibility that insight in relation to this matter is more limited than the other proposed advantages of incorporation, and certainly more limited than the owner-manager who must directly confront this issue if it arises – this

possibility could also account for the number of accountants selecting 'don't know' as an answer.

It cannot be denied that the accountancy and business-owner data does not correlate on this issue, at least in terms of the priority of satisfying customer requirements, rather than whether it is an advantage at all. In the event of uncertainty on this point it would appear sensible to trust the views of those responsible for the decision to incorporate and operate the business - the owners themselves – though this is subject to the reservation that the rationality of such reasons can be questioned based on the overall low levels of knowledge about incorporation that owner-managers appear to have prior to the event.[216] Even taking the HMRC Reasons Behind Incorporation data alone it must be stressed, as highlighted above, that just 3.5%[217] of the respondents were actually affected by such customer requirements [to incorporate] in practice, thereby indicating that they are unlikely to have had a significant part to play in the decline in the number of partnerships in recent years. The search for reason(s) therefore continues.

2.2.6 Ability to Obtain Finance

Returning to a theme discussed in relation to limited liability (above) it is understood that at least some owner-managed businesses, and seemingly a considerable number, will require access to finance at some point during the business life cycle.[218] Again, if the company form

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216 HMRC Reasons Behind Incorporation (n 25) 25.

217 35/1004.

218 Rayney (n 69) 62: 'The development of the business is invariably dictated by the availability of finance and the budgeting and control of cash flow is essential. Especially in the early phases of a business, the ability to keep the bank manager happy will often be critical to its survival.'

makes accessing finance easier as compared to a partnership, or LLP, then the business owner has a sound economic (non-tax) reason to incorporate wherever the need for finance is anticipated. One undeniable advantage of the company form is the ability to offer floating charges over the company assets (though note that this does not stop the lender from also requiring a personal guarantee to secure the debt).[219] Partnerships do not have this option, and any charges must be tied to particular assets, normally those of the owner-manager.[220] The relationship between access to finance and the corporate form is also explored in the HMRC Reasons Behind Incorporation report which includes the finding that 29% of their respondents had been advised (22% of which had received paid advice, 7% unpaid), prior to incorporation, that incorporation would make it easier to access finance,[221] though only 6% cited it as a *reason for* incorporation without prompting.[222] After prompting, this figure increased to 34%, though even then this only ranked ninth out of ten in the list of prompted considerations.[223] 24% of Freedman and Godwin's respondents indicated that an increased ability to raise finance through the company form was an important factor in the decision to incorporate, which is noticeably less than the HMRC Reasons Behind Incorporation findings. Once again, whilst the author's respondents seem to agree that financing options are important, it fell towards the bottom of the list of priorities.[224]

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219 LLPs can also offer floating charges. Note that there are limitations which make such charges vulnerable, see Gower (n 30) 1176.

220 One respondent to the author's survey expressed the view that partnerships might encounter difficulties in raising external finance.

221 HMRC Reasons Behind Incorporation (n 25) 24.

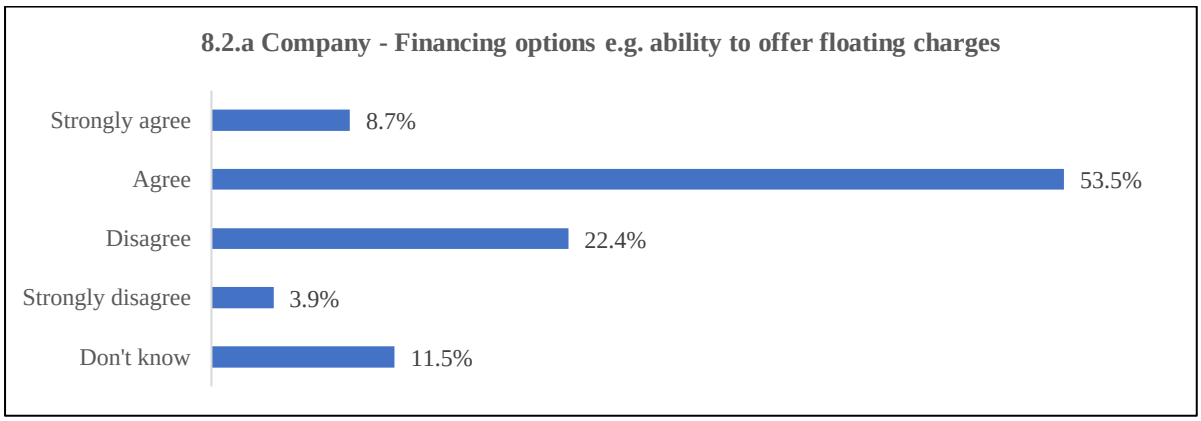
222 HMRC Reasons Behind Incorporation (n 25) 28; eighth in the list of considerations.

223 HMRC Reasons Behind Incorporation (n 25) 30.

224 Freedman and Godwin (n 32) 247.

The surveyed accountants generally agreed (62.2%)[225] that the financing options offered by the company form are an advantage for owner-managers, but the support received was considerably lower than the other listed advantages, ranking eighth out of nine provided. This option also elicited by far the highest number of 'don't know' responses.

Figure 35: Agreement that increased financing options are an advantage of the company[226]



Again, the empirical evidence on this point appears to lack the capacity to explain why partnerships are in decline. The fact that the company has a greater range of financing options available is surely accepted as a possible advantage of incorporation, but there is very little to suggest that it is having a substantial affect upon the decision to incorporate, especially if one considers the HMRC Reasons Behind Incorporation findings before prompting occurred. It is suggested that the reality of the situation is that this is yet another beneficial *consequence* of incorporation, rather than a *reason for* incorporation, though even on this front the extent of the benefit may be queried. When questioned in relation to the main benefits of incorporation, only 5% of the HMRC Reasons Behind Incorporation respondents indicated that it had been

225 222/357.

226 Cross-tabulated data for qualification, experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

easier to access finance,[227] though not surprisingly this figure increased significantly after prompting (up to 32%).[228]

2.2.7 Issue of Shares

It is only possible to issue, sell and transfer shares in a business if the business is conducted through a company.

> A partner has a proprietary interest that can be assigned (subject to the partnership deed's terms), but that assignment does not divest the assignor of his or her status or liability as a partner…an assignee will only replace the assignor as partner if all the other partners agree, and the assignor will not be relieved of any existing partnership liabilities unless the existing partners and the partnership's creditors agree, expressly or impliedly, to the release.[229]

It follows that if owner-managers anticipate that having a share structure would be helpful in the running, and possibly the later sale/gift of the business, then the partnership once again falls by the wayside as a viable form.[230] However, if the company articles of association restrict the free transferability of the shares, the position may be materially similar to a partnership,[231] and the ostensible transferability thereby becomes illusory. The share structure of the company also facilitates equity investment,[232] though the non-growth nature of the

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227 HMRC Reasons Behind Incorporation (n 25) 51.

228 HMRC Reasons Behind Incorporation (n 25) 51. Though 24% also disagreed with this proposition.

229 Gower (n 30) 44.

230 In some cases, the business may be sold to an unconnected party, though this would be atypical for the owner-managed business.

231 Gower (n 30) 46. Company (Model Articles) Regulations 2008, SI 2008/3229, Sch 1, Art 26(5) vests the director with a power to refuse the registration of a share transfer, which could have significant implications for the owner-managed business.

232 This became a feature of the company form in the second half of the nineteenth century: Armour (n 45) 13.

majority of owner-managed businesses means this is rarely a relevant consideration. Share issue also features in the HMRC Reasons Behind Incorporation Report, Freedman and Godwin's study and the author's empirical research. It may be particularly attractive to owner-managers that anticipate that younger family members (or other closely connected/related persons) will take over the running of the business in the future i.e. as an aid to succession planning, since the transfer can take place slowly with a gradual issue or transfer of shares over to the successor.[233] This may also operate as an incentive for the latter to engage more meaningfully with the business as the years progress.[234] The theoretical separation of ownership and management in the company form ought to make the transition easier.[235]

In the HMRC Reasons Behind Incorporation study, 40% of the individuals receiving paid advice (in addition to 11% that had received unpaid advice) were told that incorporating

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233 Rayney (n 69) 60-61: 'Perhaps the most significant (and often heated) issue facing many family companies is succession…[l]eading business schools have found that around 70% of family businesses struggle with succession planning. Owner managers regularly find it difficult to give up control and often fear that their children might damage the business.' It appears that the tradition of inter-family succession is declining: 'According to recent research, less than one in five UK family firms continue to "reserve" managerial positions for members of the family…[i]n many cases, owner managers will tend to seek an exit from their business, rather than take the chance that their children will be able to carry on the business. In the author's experience, relatively few people now follow their parents into the family business. The general strategy for the majority of owner-managed companies today seems to be to grow the business for a successful trade sale or management buy-out exit…

The key issues for the owner-manager [in relation to succession planning] are:

- Whether members of the family have the necessary acumen and skills to develop and run the business (and do they want to)?
- Can the existing family members achieve the true potential of the business?
- Would it be better to bring in an outside to take of the company (perhaps under a management buy-in)?'

234 The ability to reward employees with share issues as an incentive to work hard is a frequently cited advantage of the company form. This research focuses upon the owner-managed business so has taken a narrower interpretation of the advantage for the purposes of discussion herein, but that is not to say that the former has not been recognised and may be pertinent to an owner-managed business that anticipates future expansion.

235 However, the separation rarely occurs in practice – though it may be something which is put into effect by succession planning, due to the original owner-manager (parent) wishing to retain control. In this case, the parent would retain a majority shareholding whilst (at least ostensibly) handing over management of the business to the child/children.

would allow the company to issue shares.[236] This is the same number of respondents that had been advised that incorporation would result in limited liability and so would appear to feature frequently in the advisory process.[237] Furthermore, 69% of the participants correctly recognised the fact that incorporation was necessary to enable the issue of shares. [238] These figures suggest that the ability to issue shares etc. is a selling point of the company form, and therefore could provide a good economic reason for the decline in the number of partnerships.[239] However, it is also true that in tying ownership to shares, the company is 'less flexible than the partnership in terms of assigning ownership'.[240]

The accountants responding to the author's study appeared to agree that this is a significant advantage, which is consistent with the experience of owner-managers in the HMRC Reasons Behind Incorporation study having frequently received advice in relation to share issues. It ranked fifth in the list of prompted advantages, with 87%[241] agreeing. One accountant added the following comment in the free text response: '*[t]he ability to buy back its own shares where the shareholders fall out is really useful.'* The dispute resolution issue is discussed in more detail in Part 2.3.5 since it is not always as simple as this comment would indicate – the company form can actually complicate matters in this respect.

236 HMRC Reasons Behind Incorporation (n 25) 24.

237 HMRC Reasons Behind Incorporation (n 25) 24.

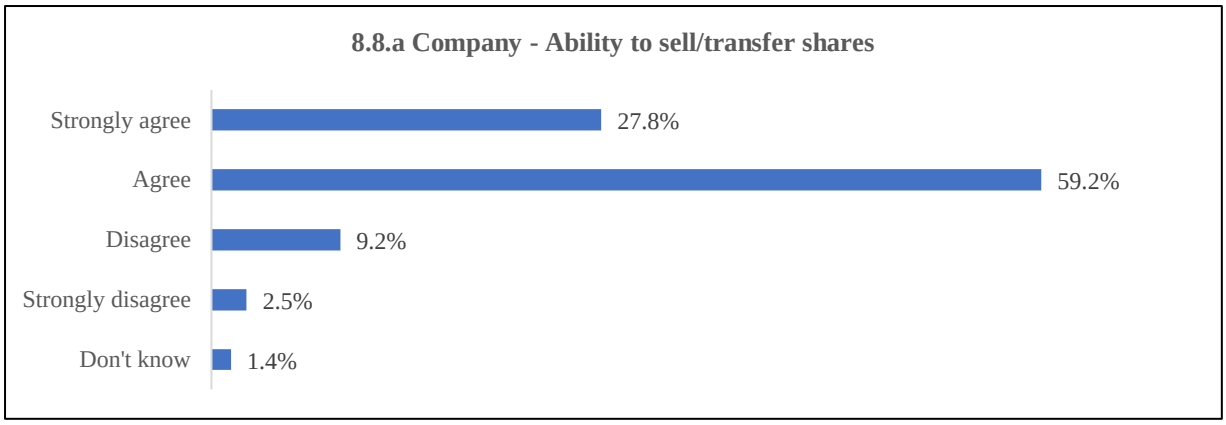
238 10% thought that it was unnecessary. 21% didn't know. HMRC Reasons Behind Incorporation (n 25) 26.

239 Armour (n 45) 9.

240 Armour (n 45) 14.

241 313/360.

Figure 36: Agreement that ability to sell/transfer shares is an advantage of the company[242]



If one compares the findings of the HMRC Reasons Behind Incorporation study, only 2% of the respondents said (unprompted) that the ability to issue shares was a main reason for incorporating; last in the list of 12 reasons offered.[243] The percentage increases if the prompted responses are considered, at which point 37% agreed that the ability to issue shares was an important consideration in the decision to incorporate, but this still only ranks eighth in the list of prompted considerations. The HMRC Reasons Behind Incorporation survey also offered 'easier to sell or transfer ownership of the business' as a prompted response i.e. one of the primary advantages associated with a business adopting a share structure, but this surprisingly ranked last on the list of prompted considerations (32% agreeing) with a high percentage (39%)[244] of respondents disagreeing. Freedman and Godwin framed the consideration in terms of 'ease of transferring shares' but got an equally lukewarm response from their participants, only 17.6% of which considered that it was an important factor.[245]

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242 Cross-tabulated data for qualification, experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

243 HMRC Reasons Behind Incorporation (n 25) 28.

244 HMRC Reasons Behind Incorporation (n 25) 30.

245 Freedman and Godwin (n 32) 247.

It is possible, that at least at the point of incorporation, owner-managers are not considering the succession planning element. Indeed, the difficulties encountered in establishing, or maintaining, a successful business are likely to be more of a focus in the initial stages of business for owner-managers, thereby explaining the lack of priority of succession planning in early years.[246] Where the business is viable in the long term, the ability to transfer shares will no doubt become more of a concern. It is a reasonable assumption that accountants are more likely to be forward-looking in the long term than owner-managers making the initial decision to incorporate, which entails consideration of possible succession planning. The difference in the nature of the questions may have a role to play in the disparity between the two sets of results presented; the HMRC Reasons Behind Incorporation questions were focused upon the *reasons for incorporation* whereas the form of the author's questions posed to accountants was in relation to *advantages associated with incorporation* – the latter does not necessarily entail the former. Therefore, whilst the ability to issue shares will no doubt be an advantage to some owner-managed businesses, the fact that it seems to have limited capacity to account for the decision to incorporate means that it is unlikely to be a significant factor in the decline in the number of partnerships.

2.2.8 Company Advantages (Overall)

Analysis of the data thus far indicates that, whilst incorporation does attract some (non-tax) benefits for owner-managed businesses, the odds are not so convincingly stacked in favour of

246 5% of the HMRC respondents said that the ability to issue shares was a main benefit of incorporation after the event, which would support this hypothesis; HMRC Reasons Behind Incorporation (n 25) 51.

Office of Tax Simplification, *Simplifying Everyday Tax for Smaller Businesses: A Further Business Lifecycle Review*, May 2019, 19 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/801469/Simplifying_everyday_tax_for_smaller_businesses_-_print.pdf> accessed 3 April 2022: 'Starting up business is challenging in itself. Most businesses in their early stages are preoccupied with survival.'

the company, and against the partnership, as it may have initially appeared. From highest-lowest levels of agreement, the author's survey produced the following order of commercial advantages for the company form:[247]

1. Limited liability;
2. Separate and continuing legal personality;
3. Formal business structure;
4. Ability to sell/transfer shares;
5. Prestige/credibility;
6. Financing options e.g. ability to offer floating charges;
7. Satisfying customer requirements.

It is critical to note that the primary advantage of 'limited liability' is incomplete, mainly due to the practice of requiring personal guarantees. However, in circumstances where personal guarantees are not required, the benefits of insulating personal assets, particularly the family home, from business creditors is undeniably attractive; in this case, the company form is a logical option. Separate and continuing personality is also beneficial to some, and seemingly an important consideration in the incorporation process. Based on the data obtained, benefits such as a formal business structure and enhanced credibility do not appear to generate a corresponding disbenefit when operating as a partnership; this is somewhat surprising. Other matters (customer requirements, increased financing flexibility, and the ability to offer shares) do make the company more attractive in some respects, though without more do not offer compelling reasons for the decline in the number of partnerships – the author's findings are

[247] By way of spoiler, tax treatment came third in the list, and pension flexibility was seventh. See Chapter 4 for further discussion.

similar to that of Freedman and Godwin in this respect in that 'survey evidence suggests that although the predicted economic or legal reasons for using the limited liability company are important, some, such as raising finance and transferring shares, are perhaps less significant than had been anticipated.'[248]

One ought also to be hesitant to place too much weight on the reasons for incorporation offered by the business owners as part of the HMRC Reasons Behind Incorporation study, given that a significant majority of them knew very little or nothing about incorporation, as can be seen in Figure 37 below.[249] The consequence might be that the respondents offered what they believed to be sensible reasons for incorporation, rather than the truly motivating ones. This has to be a matter of concern because:

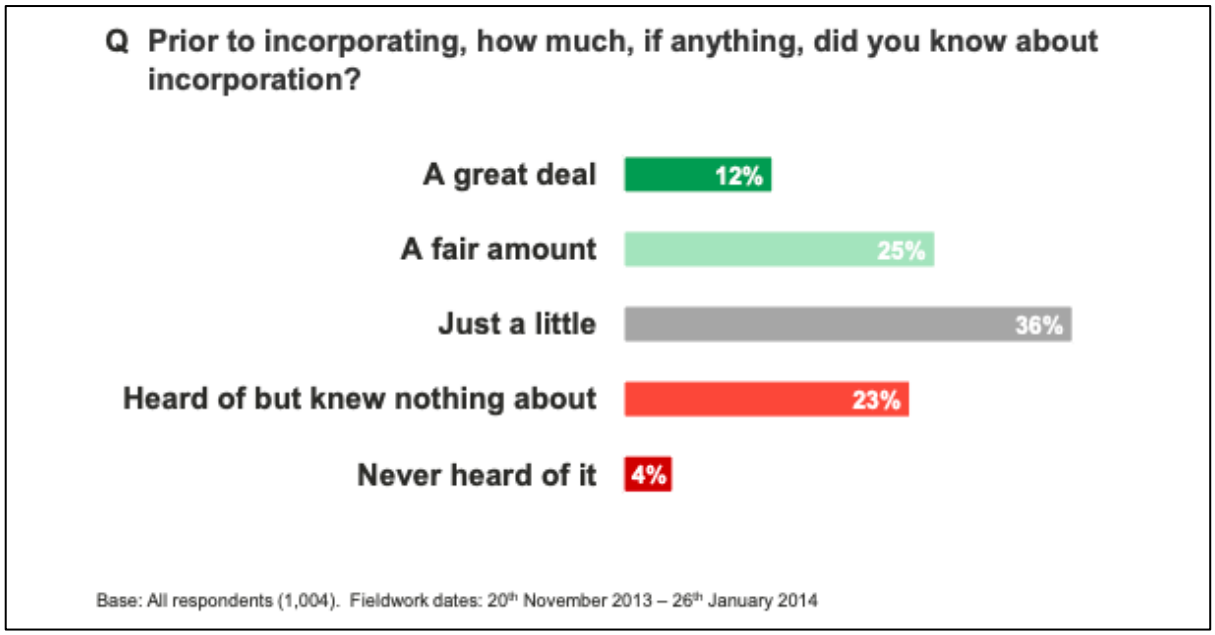
> [m]isconceptions about legal form may result in small and simple firms taking on responsibilities, duties and procedures more appropriate to larger and more complex firms: and thus they may find themselves operating less efficiently and economically than they might otherwise have done. [250]

248 Freedman and Godwin (n 32) 249.

249 HMRC Reasons Behind Incorporation (n 25) 25.

250 Freedman and Godwin (n 32) 249.

Figure 37: HMRC Reasons Behind Incorporation[251] findings in relation to knowledge prior to incorporation



In any event, the case in favour of the company as the form of choice for owner-managers also becomes less compelling if the disadvantages associated with incorporation are considered. This forms the subject matter of the following part of this Chapter.

2.3 COMPANY DISADVANTAGES

McLaughlin and Anderson warn: [252]

> [l]est the reader be lulled into a false sense of security, it should not necessarily be thought that everything is rosy on the corporate side of the fence. There are disadvantages to the process, many of which will seem to be proportionately bigger to the typical businessman looking to incorporate solely for tax savings.

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251 Freedman and Godwin (n 32) Figure 4.4.

252 (n 124) 84. Tax-motivated incorporation is explored in Chapter 4.

Freedman and Godwin further observe that: [253]

> cultural reasons [for incorporation] – must …be taken into account. These can be summed up in terms of the prestige which companies are perceived to have. Such reasons seem to have been encouraged by policy makers in promoting the 'enterprise culture'. As the idea that incorporated companies have greater prestige than unincorporated firms[254] appears to be pervasive in the business community, a choice based on this factor is not 'irrational' or unreal but…as the costs of incorporation become apparent…those who incorporated for such cultural reasons would be [are] less satisfied with the corporate form than whose incorporating primarily for what we have called here 'legal and economic' reasons for whom the costs would be more likely to be acceptable as conferring some benefit.

As indicated in the above passages, there are numerous drawbacks to operating in the company form, the burden of which can fall heavily upon owner-managed businesses regardless of the reasons for incorporation.[255] This may be taken as a reflection of the fact that the company was not designed with small businesses in mind.[256] Whilst there have been some targeted simplification measures introduced with a view to alleviating this burden, such as the removal of the statutory audit requirement for small businesses,[257] generally, there has been a

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253 Freedman and Godwin (n 32). This is stated as a hypothesis at 249 but is ultimately supported by the data presented at 254-255.

254 Though note that the author's data suggests that this view is not shared by the accountancy profession.

255 McCahery and others (n 40) 2.2.

256 Harford (n 43); John Birds, 'A new form of business association for the 21st Century' (2000) Company Lawyer 29; House of Commons Trade and Industry Committee, *The White Paper on Modernising Company Law*, Sixth Report of Session 2002-2003, 5: 'A significant component of the Review has been concerned with simplifying company law covering small companies. The current company law framework was conceived with large companies in mind and a complicated series of exemptions has been used to modify the regime for small companies.'

257 CA 2006, s 477. The DBEIS has conducted empirical research in relation to this exemption; DBEIS, *The Impact of Exempting Small Companies From Statutory Audit*, 1. 9 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/583972/audit-exemption-small-companies-impact.pdf>: 'Up to 90 per cent of all UK registered companies – especially smaller companies without shareholders – were likely to have benefited from the Government's small company audit exemptions in 2015, and this figure is expected to grow in the future,' and: 'The average saving reported by those who experienced benefits was £3,960 per company per annum. The average savings were slightly higher amongst those who were ineligible before 2012 (£4,500 per annum) compared to those that were eligible before and after 2012 (£3,600 per annum).'

'sustained and prolonged increase'[258] in the legal and regulatory demands of companies such as:

- Payroll reporting under real time information (RTI);
- Employment law obligations;
- National minimum wage requirements;
- Health and safety regulations;
- Anti-money laundering registration;
- Auto-enrolment (AE).[259]

The HMRC Reasons Behind Incorporation report did find that 52% of the respondent business owners were fully aware that there would be drawbacks to incorporating, meaning that perhaps even where the burden is heavy, owner-managers simply accept that such is the price to pay for incorporation.[260] That would be fine but for the fact that it follows that the remaining 48% did not anticipate such drawbacks:

> [m]isconceptions about legal form may result in some small and simple firms taking on responsibilities, duties and procedures more appropriate to larger and

Freedman and Godwin (n 32) 250 reported this as the primary disadvantage of incorporation for owner-managed businesses, with 72% of their respondents agreeing.

Reforms relaxing accounting and reporting requirements for small companies have also been extended to small LLPs: Small Limited Liability Partnerships (Accounts) Regulations 2008, SI 2008/1912; Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016, SI 2016/575.

258 OTS Small Company Taxation Review (n 40) 65.

259 OTS Small Company Taxation Review (n 40) 65, 66. Tom McGhie, 'Small firms' burden of admin costs UK £4.7bn', *The Telegraph*, 17 April 2015 <https://www.telegraph.co.uk/finance/enterprise/11543508/Small-firms-burden-of-admin-costs-UK-4.7bn.html> accessed 3 April 2022. Changes were made to the automatic enrolment system by the Occupational and Personal Pension Schemes (Automatic Enrolment) (Miscellaneous Amendments Regulations) 2016, S1 2016/311: auto-enrolment for directors became entirely discretionary.

260 HMRC Reasons Behind Incorporation (n 25) 35.

> more complex firms; and thus may find themselves operating less efficiently and economically than they might otherwise have done.[261]

Incorporation based on such misconceptions often occurs when owner-managers incorporate without professional advice and/or where the incorporation is the result of a false belief that a business can only be conducted through the company form.[262] This is facilitated by an ethos of easy incorporation in the UK[263] – the fee to file directly with the Companies House at present is just £12, and the registration process as a whole has been made significantly easier following the introduction of a single portal (in May 2017) that enables registration for tax purposes contemporaneously with the creation of the company.[264] 99% of companies now appear to incorporate online, with approximately a third using the Companies House website, with two-thirds using third parties.[265] Indeed, the OTS Small Company Tax review stakeholder meetings considered whether incorporation in the UK was too easy.[266] The responses indicated that the solution was to ensure that appropriate guidance was given as to the responsibilities and obligations associated with the company form,[267] but whilst this may be necessary, it is unlikely to be sufficient.

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261 Freedman and Godwin (n 32) 249.

262 OTS Small Company Taxation Review (n 40) 78: the report also provides examples of common problems that result from a lack of professional advice; 'new companies created with excessive share capital; a lack of appreciation of the duties and legal responsibilities of directors and shareholders; incorporation at too early stage in the business' evolution… some respondents considered that companies were formed "by accident" on the false understanding that this was the only available way to set up a business.'

263 Dating back to the 1855 Limited Liability Bill according to Crawford and Freedman (n 5) 1043.

264 GOV.UK, *Register Your Company*, <https://www.gov.uk/limited-company-formation/register-your-company> accessed 3 April 2022. The OTS Small Company Taxation Review (n 40) 77 observed that 'of the 99% who incorporate online, approximately a third use the Companies House website with two-thirds using third parties [it can cost] anything from £30 to several hundred pounds if done via agents.' The author explored the costs point in the survey: see Figures 47, 52, 136.

265 OTS Small Company Taxation Review (n 40) 77. See also 65: 'Some of those consulted were concerned that fundamental mistakes made on formation subsequently prove costly to put right, for example allotting themselves large amounts of shares because it seemed a good idea at the time.'

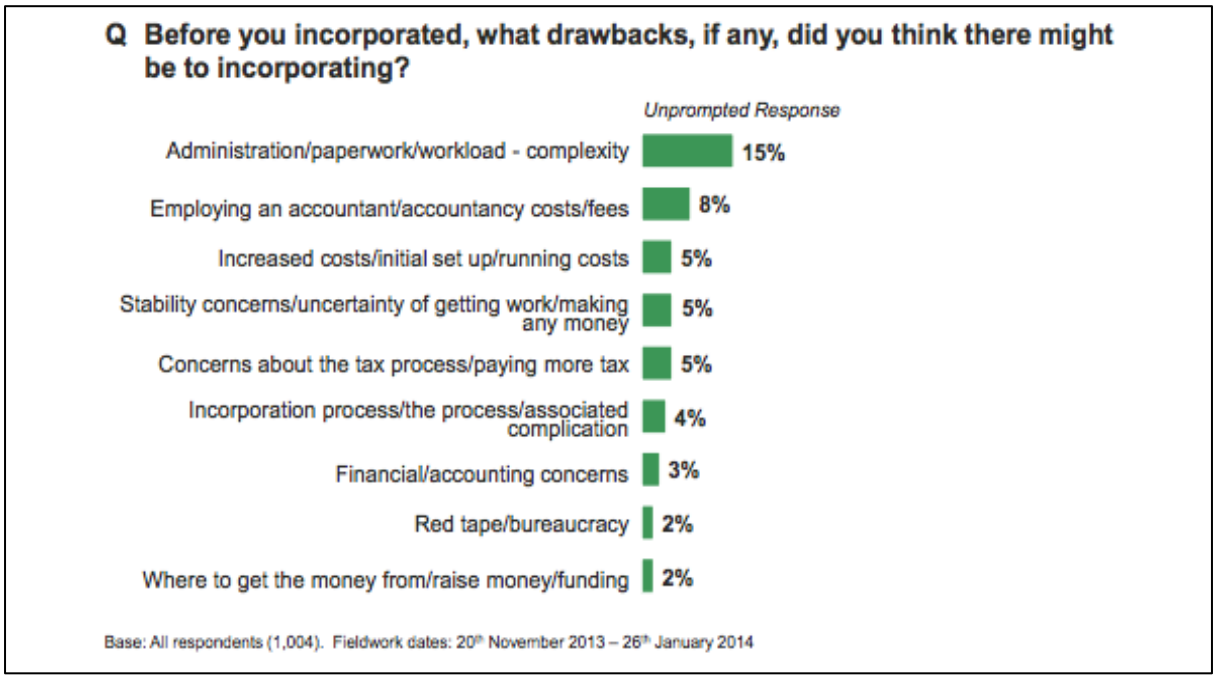
266 OTS Small Company Taxation Review (n 40) 77.

267 OTS Small Company Taxation Review (n 40) 77.

A further problem is presented by the fact that even businesses that incorporate anticipating that there will be associated drawbacks sometimes face an unpleasant surprise when the burdens are more onerous than expected.[268]

The key drawbacks of incorporation identified by the HMRC Reasons Behind Incorporation study are included in the following chart.

Figure 38: HMRC Reasons Behind Incorporation anticipated drawbacks to incorporation[269]



The author's empirical work also explored the disadvantages associated with incorporation for owner-managed businesses, based upon an amended version of the list used by Freedman and Godwin in their study.[270] The survey asked the respondents to what extent they agreed that

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268 HMRC Reasons Behind Incorporation (n 25) 5.

269 HMRC Reasons Behind Incorporation (n 25) Figure 5.3, 35.

270 Freedman and Godwin (n 32) 150. The list of seven possible disadvantages were: cost of statutory audit; administrative burdens; lack of confidentiality; expense and complexity of setting up; the need for two shareholders; loss of personal control; loss of control over capital.

the following were disadvantages of forming/operating through a company for owner-managed businesses:

- Expensive and complicated to set up;
- Costly administrative/compliance burdens;
- Inflexible business structure;
- Formality requirements for dissolution;
- Lack of privacy.

As with the advantages portion of the survey, the respondents were also invited to cite any additional significant disadvantages that owner-managers face when forming/operating as a company. 14 free text responses indicated that they had encountered difficulty in getting owner-managers to comprehend the legal separation of the company and that they should not treat its assets as personally owned.[271] Accordingly, there is additional consideration of this point at 2.3.6 below.[272]

2.3.1 Administrative Burdens

There is no doubt that additional compliance and administrative burdens attach to the running of a company, as compared to an unincorporated form – 'running a business through a company requires compliance with Companies House legislation, as well as additional HMRC

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271 44 participants offered additional comments on this question, 1 of whom suggested that a 'subject to circumstances' (or similar) option was the best response to each.

272 One accountant mentioned that insurance may become more expensive with incorporation. This is also recognised by McLaughlin and Anderson (n 124) 262.

compliance requirements for directors.'[273] 'So far as the sole trader [and partner] is concerned, the tax and regulatory regime they will need to deal with will be simpler if they can remain a sole trader [or partner]'.[274] McLaughin and Anderson conveniently summarise the position as follows:[275]

> [t]here is, it has to be said, substantially more administration in the running of a company than any other form of business. A lot of this stems from the fact that the company is an entirely separate entity. It is governed in operation by the Companies Act 2006 (CA 2006) which places certain obligations on the owners. These include requirements for meetings, maintenance of statutory books, the submission of an annual return etc…
>
> Additionally, an acceptable minimum of accounting is required (sorry, incorporation does mean the end of brown bag accounts).
>
> All of these require a business to have administrative systems in place to cope with such niceties. The alternative must be acceptance of the need for continuing professional help…
>
> Although many small companies will not require an audit of their accounts, the accounting procedures adopted will often be more stringent…Whilst eligible small unincorporated businesses may elect (under ITTOIA 2005, s.25A) to

273 Office of Tax Simplification, *Small Business Taxation Review Interim Report*, 2011 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/199183/05_ots_small_business_interim_report.pdf> accessed 3 April 2022; OTS Small Company Taxation Review (n 40) 10 '[i]ncorporating creates a significant problem for many micro businesses, especially nanos. Many proprietors simply do not understand the accounting and tax requirements of a company but are comfortable with the requirements of an unincorporated business'; The Tax Reform Commission, *Tax Matters, Reforming the Tax System*, October 2006 <http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/19_10_06tax.pdf> 81, accessed 3 April 2022: 'The administrative burden of UK tax regulation falls more heavily on SMEs than on larger firms.' . A more detailed account of the administrative burdens can be found at: KPMG, *Administrative Burdens – HMRC Measurement Project*, 2006 <https://webarchive.nationalarchives.gov.uk/+/http:/www.hmrc.gov.uk/better-regulation/part7.pdf> accessed 3 April 2022. See also: Rayney (n 68) 27.3, who notes that the additional administrative burdens may also amount to commercial disadvantages e.g. the need to provide shareholders with financial accounts.

274 OTS SEPA Report (n 36) 5. See also OTS Disincorporation Relief Report (n 200) 15: 'As part of the research, we asked about the costs of advice for ongoing small businesses. Unsurprisingly, the vast majority of the OTS agent survey sample charge more in fees to limited companies than to equivalent unincorporated businesses. The most common response (26%) was that fees are between 25% and 50% higher for limited companies, while 36% of the sample said that fees are at least 50% higher… TFC survey data also shows that sole traders (and partnerships) on average spend significantly less on dealing with their tax affairs than limited companies: 13% of sole traders spent more than £500 per year, compared to almost 75% of limited companies. However, in this data, it is not possible to separate this difference in cost from the underlying complexity of the tax affairs of the business.'

275 McLaughlin and Anderson (n 124) 84-85.

> apply the cash basis in calculating its profits, as opposed to UK GAAP (for 2013/14 and later years), this facility is not available to companies.
>
> Incorporation will lead some small businesses to the operation of PAYE procedures for the first time…the pure sole trader or husband and wife partnership may not have encountered it before…the requirement to operate PAYE in real time (real-time information) is an additional administrative burden.

According to the micro companies' feedback to the OTS the existence of such burdens typically results in an owner-managed company paying professional fees of around £1,850 per year just to manage their accounts and tax.[276]

However, there is a cautionary note when considering the real effects of the burdens upon owner-managers; there is evidence to suggest that there is considerable non-compliance with corporate filing responsibilities, such that the theoretical burdens do not always actually exist.[277] Freedman and Godwin have also observed that some legal requirements might not cause owner-managers too much concern:

> more internal, requirements…can simply be ignored by owner-managed companies as performance can be perfunctory or fabricated and cannot be monitored effectively…Therefore complex or unsuitable rules do not always appear to impose compliance costs. It follows that provisions designed to give relief from such supposedly burdensome rules will not be particularly helpful.[278]

In any event, 'administration/paperwork/workload – complexity' was by far of the most concern to the HMRC Reasons Behind Incorporation respondents with 15% citing the issue

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276 Rob Durrant-Walker, '*Aiming For Alignment'*, Taxation Magazine, 6 April 2016 <https://www.taxation.co.uk/Articles/2016/04/05/334568/aiming-alignment> accessed 3 April 2022.

277 OTS Small Business Taxation Interim Report (n 273) 31.

278 Freedman and Godwin (n 32) 252. Though the CA 2006 abolished the obligation for private companies to hold annual general meetings.

unprompted.[279] In a similar vein, the costs of employing an accountant (8% respondents), financial/accounting concerns (3% respondents) and red tape/bureaucracy (2% respondents) were also identified as drawbacks of incorporation – these might be regarded as falling under the general umbrella of administrative and compliance burdens.[280] They also featured highly in the list of disadvantages reported by Freedman and Godwin with 52% of small business owners saying that administrative burdens were a problem of incorporation.[281] 65% of the HMRC Reasons Behind Incorporation respondents believed that 'the overall costs of administrative tasks related to incorporation were about the same as expected'; this leaves a significant proportion (23%) reporting that they were higher than anticipated.[282] Also noteworthy is that:

> [r]espondents were more likely to say that costs were higher than expected if the company had a low turnover (30 per cent of those with a turnover of under £25,000). This was also more common where respondents had received unpaid advice prior to incorporation (33 per cent), and where they had limited advance knowledge of incorporation (28 per cent of those who know little or nothing about it).[283]

The first point is important. Businesses with a lower turnover bear the burden in significantly greater proportions than those with a high turnover. This means that where paid

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279 HMRC Reasons Behind Incorporation (n 25) 35. Although one respondent to the qualitative interviews said that the ability to set up a company online had reduced the administrative burden involved. Another commented, 58: 'Incorporation requires a lot of energy, lots of reading and forms to complete, it requires time and willpower. You need to find about it all, contact colleagues, contact an accountant, weigh it all up, separate things mentally, put all the structures in place, so it's a lot!"

280 HMRC Reasons Behind Incorporation (n 25): 'Concerns about the tax process/paying more tax' (5% respondents) could also be added to this list, but because of the reference to payment of tax it has been omitted as this is without doubt a separate point to administrative and compliance burdens which are more procedural in nature.

281 Freedman and Godwin (n 32) 250.

282 HMRC Reasons Behind Incorporation (n 25) 56.

283 HMRC Reasons Behind Incorporation (n 25) 57.

assistance is required, the profitability of the businesses is deeply (and further) impacted upon. If one also considers that 'the UK has a long tail of low-productivity firms',[284] the distinct lack of economic efficiency in this respect must be a cause for concern. Indeed, the HMRC Reasons Behind Incorporation survey found that as many as 34% of their respondents agreed that administration was too much of a burden on their business. Again:

> [a]ttitudes to the administrative burden were linked to financial position: those with a low turnover (less than £25,000) were more likely to agree that the administration was too much of a burden (44 per cent), as were those who broke even (49 per cent) or made a loss (42 per cent) rather than made a profit.[285]

Notwithstanding the ability of owner-managers to ignore some of the internal governance requirements of the company form, non-compliance in relation to filing obligations simply is not an option for owner-managers. A failure to comply with Companies House requirements can, and often does, lead to being struck off the company register,[286] and late completion of tax returns generates penalties of increasing severity.[287]

Respondents to the author's survey also indicated that administrative and compliance burdens were a disadvantage encountered by owner-managers when operating as a company – 51.3%[288] agreed overall, which correlates with Freedman and Godwin's findings, though there

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284 Cribb, Miller and Pope (n 4) 5. Though companies do appear to be the most profitable of the business forms. According to one survey respondent: 'too often government advisers or agencies are keen to promote company formation counting the number of new registered companies appears to be a Government objective as a measure of economic activity. False data… the UK has low productive growth or productivity improvement.' The respondent proceeded to make comparisons with the German approach to partnerships and companies.

285 HMRC Reasons Behind Incorporation (n 25) 57.

286 McLaughlin and Anderson (n 124) 84: 'Just to put the frighteners on, some breaches of the CA 2006 are criminal offences.'

287 HMRC Reasons Behind Incorporation (n 25) 59: 'Without an accountant you could get into would have struggled with all the forms that you actually fill in.'

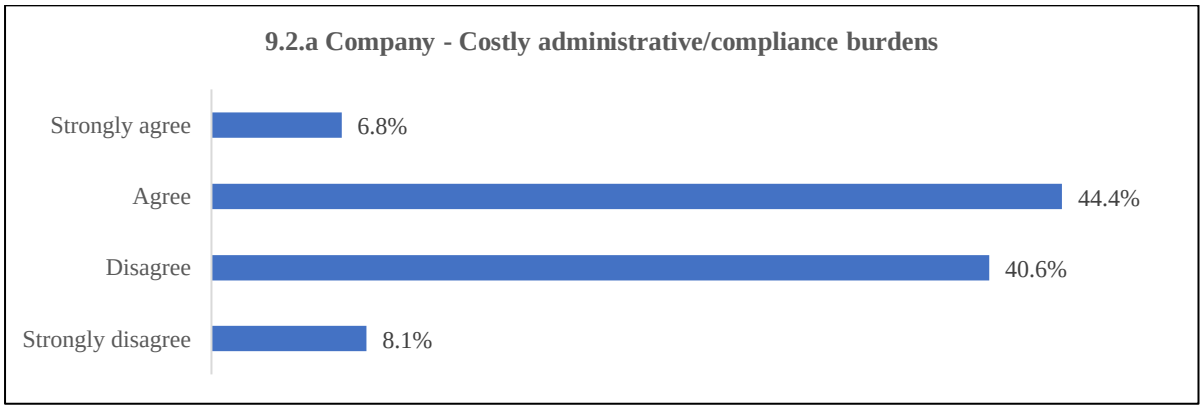
288 185/360.

is clearly a split of opinion on this point, with some accountants indicating that the administrative requirements could be an advantage.

> *'We find that an indiviual [sic] trading as a Limited Company is more diligent in their approach to running a business due to various legal and accounting requirements.'*
>
> '*Formalitiy [sic] of reporting requirements tends to mean accounts are more thorough, potentially making the true financial picture clearer.'*
>
> *'[An advantage of the company form is] being able to be put through the payroll scheme in the Ltd co.'*

Overall, the administrative and compliance burdens ultimately ranked second highest in the proposed list of disadvantages. It should also be borne in mind that accountants are likely to deal with such burdens on a frequent basis, thereby alleviating the owner-manager of the perceived trouble and may therefore be desensitised to their potential affect upon the owner-managers on a personal level.

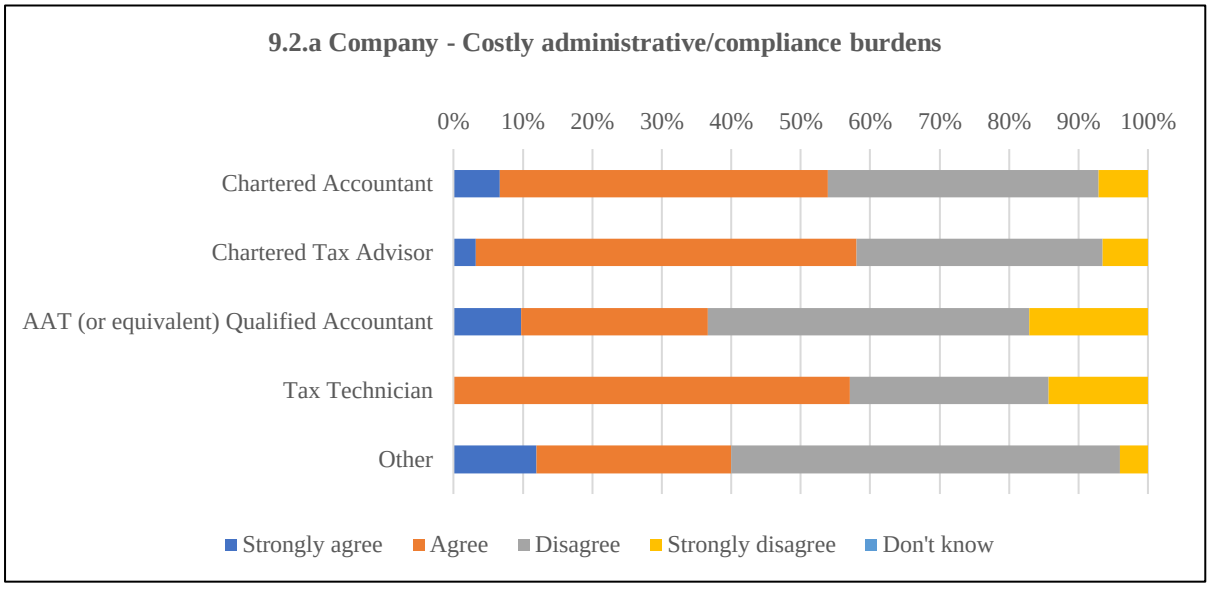
Figure 39: Agreement that administrative and compliance burdens are a disadvantage of the company[289]



[289] 0 'don't know' responses received.

Once more, cross-tabulation of the data demonstrates the variety of views expressed between accountants possessing different forms of qualification (Figure 40) and those based in different firm sizes (Figure 42), but without any notable trends. If the responses are considered by reference to length of time advising, it is apparent that the more experienced the accountant, the less likely they were to agree that administrative and compliance burdens were a disadvantage associated with the company form, perhaps reflecting an increased familiarity with the company (27.3% 1-5 years' experience agreed;[290] 22.6% 6-10 years' experience agreed; 18.1% more than 10 years' experience agreed) (Figure 41).

Figure 40: Agreement that administrative and compliance burdens are a disadvantage of the company, by reference to qualification



[290] 6/22 in the 1-5-years' experience category; 7/31 in the 6-10 years category; 55/263 in the more than 10 years category.

Figure 41: Agreement that administrative and compliance burdens are a disadvantage of the company, by reference to experience

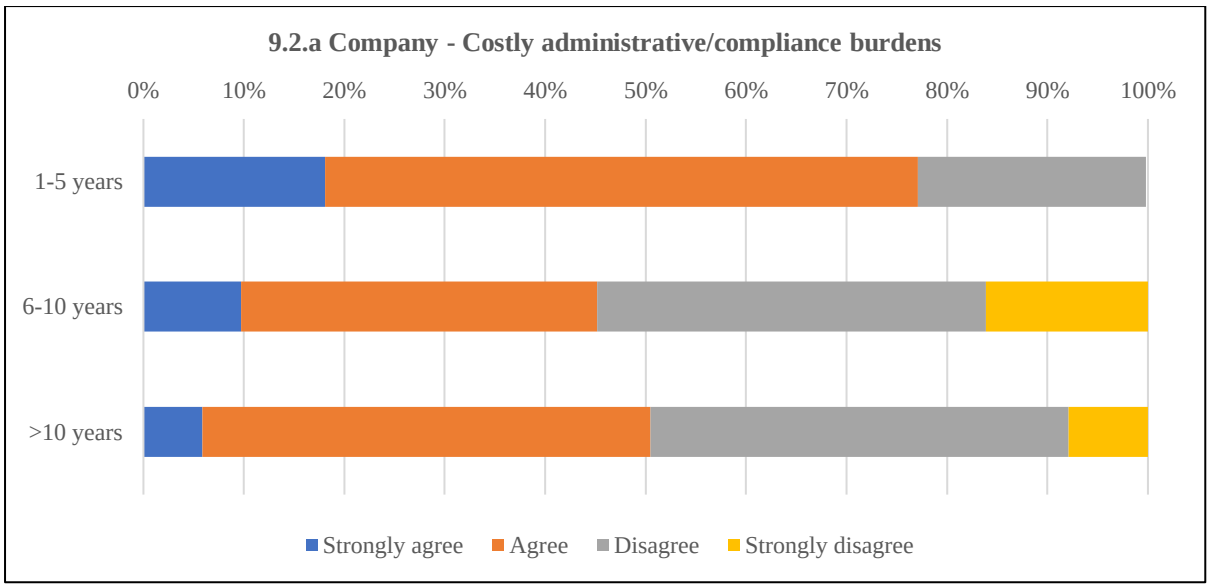
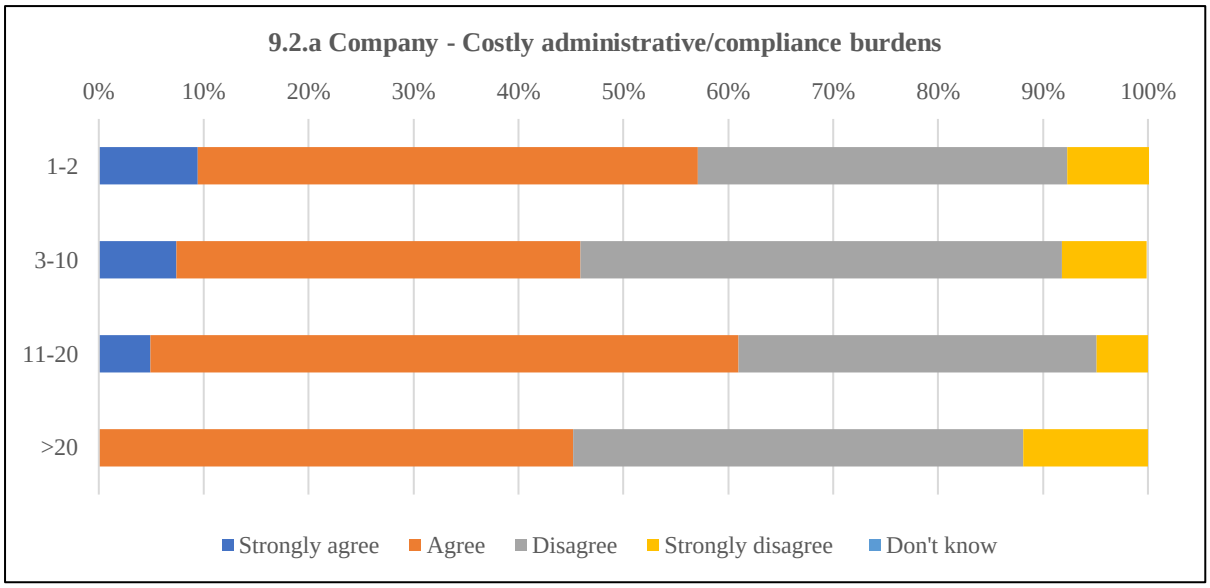
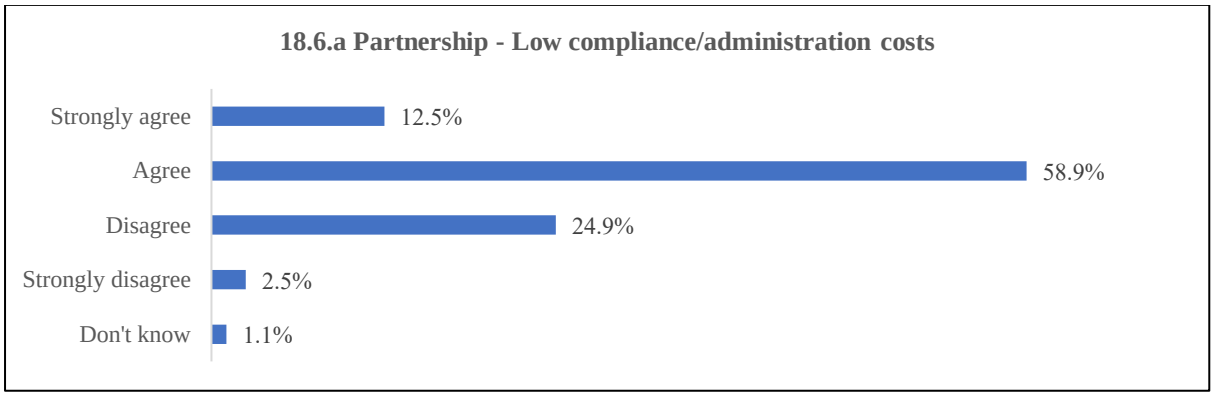


Figure 42: Agreement that administrative and compliance burdens are a disadvantage of the company, by reference to firm size



By way of comparison, the respondents were generally more positive about the compliance and administration costs of operating through a partnership. When asked if they agreed that low compliance and administration costs were an advantage of the partnership form 71.4%[291] agreed that this was the case.

Figure 43: Agreement that low administrative and compliance burdens are an advantage of the partnership[292]



The respondents self-identifying as Tax Technicians[293] and 'Other' [qualifications] adopted, on the whole, very positive views about the partnership in terms of compliance and administrative burdens (100%[294] and 84%[295] respectively agreeing that such costs were low when operating as a partnership).

291 252/353.

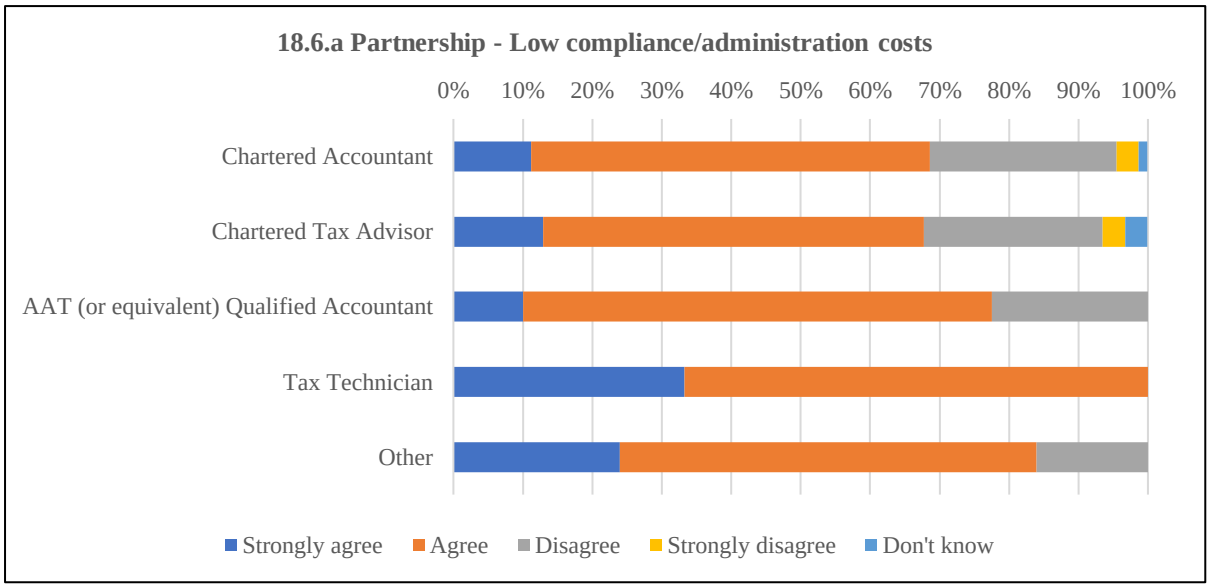
292 Cross-tabulated data for experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

293 Though this category was only comprised of 6 respondents, so the data must be treated with caution.

294 6/6.

295 21/25.

Figure 44: Agreement that low administrative and compliance costs are an advantage of the partnership, by reference to qualification

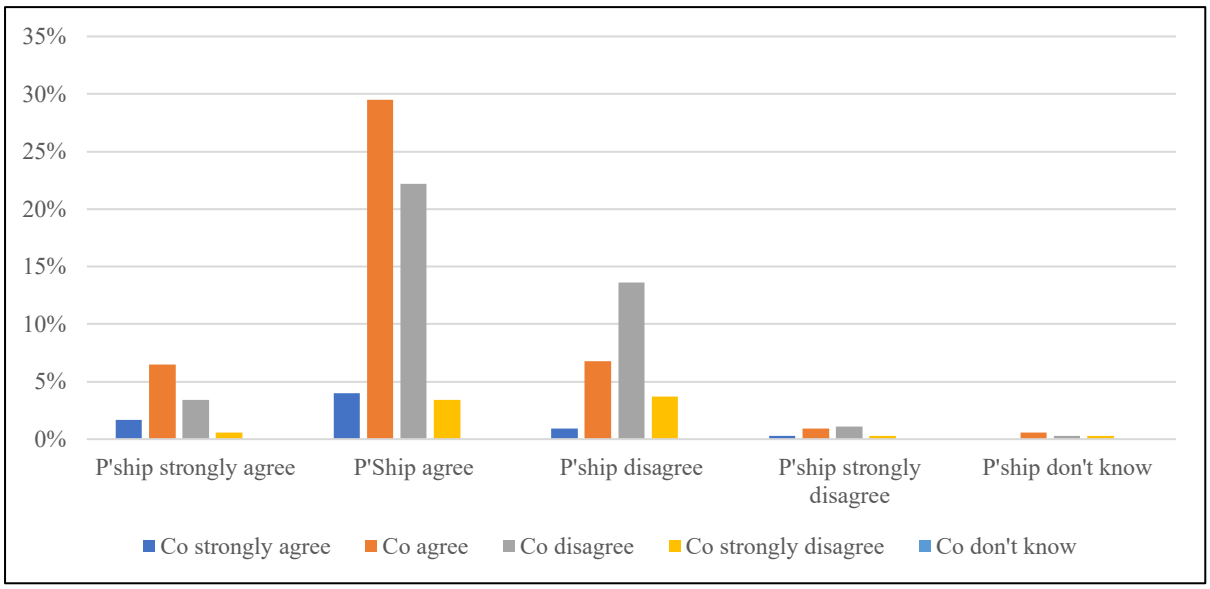


41.8%[296] of the respondents agreed that the administrative and compliance burdens associated with the company form were a disadvantage, whereas the low compliance and administration costs associated with the partnership form were an advantage. However (consistently with the overall views on company administrative and compliance costs) a significant proportion of respondents thought the costs associated with both forms were low (29.6%).[297]

296 147/352.

297 104/352.

Figure 45: Agreement that compliance costs are a disadvantage of the company, and that low compliance costs are an advantage of the partnership



In light of the above, it is difficult to dispel the impression that, in so far as administrative and compliance burdens are concerned, the partnership can offer a much more attractive structure for owner-managed businesses, even if the respondents to the author's survey were generally more positive about the company than was expected. The partnership is particularly beneficial if the business has a low turnover, breaks even, or generates losses, since the costs burden has disproportionate effects thereupon.

2.3.2 Start Up Costs

Even before the administrative costs of running the business are incurred, any owner-manager(s) seeking advice and assistance with the incorporation process will inevitably incur more costs - though it is, of course, a one-off sum to pay. Those choosing to 'go it alone' need only pay the Companies House fee of £12, which would be of little concern. Invoking the assistance of a company formation agent (of which there are many, and easily accessible with

a Google search) will also result in a small fee being charged, typically from £13-£20 for a non-bespoke service. For the approximately 63% of owner-managed businesses seeking paid advice[298] the costs will inevitably be higher even where a bespoke service is not required. Owner-managers' concerns about set up costs is reflected in the Freedman and Godwin survey results, whereby 33.6% of the respondents indicated that the expense and complexity of setting up a company was a disadvantage of incorporation.[299] There have been numerous reforms since the survey was conducted in 1999 that have no doubt reduced such costs. Notable developments include the introduction, with effect from the 1 October 2009, of the company model articles of association, which replaced an earlier set of more complex default rules, [300] and the availability of online incorporation through the Companies House. Even so, set up costs were still identified as an anticipated drawback of incorporation by 5% of the HMRC Reasons Behind Incorporation respondents (unprompted), ranking joint third of the listed disadvantages; though it should be noted that the Report puts this in a category alongside increased costs (generally) and running costs, making it difficult to identify exactly what proportion of respondents specifically referenced set up costs.

The respondents to the authors survey were generally resistant to the notion that the company was expensive and complicated to set up; only 18.9%[301] agreed with the proposition that this was a disadvantage of the company form for owner-managed businesses.

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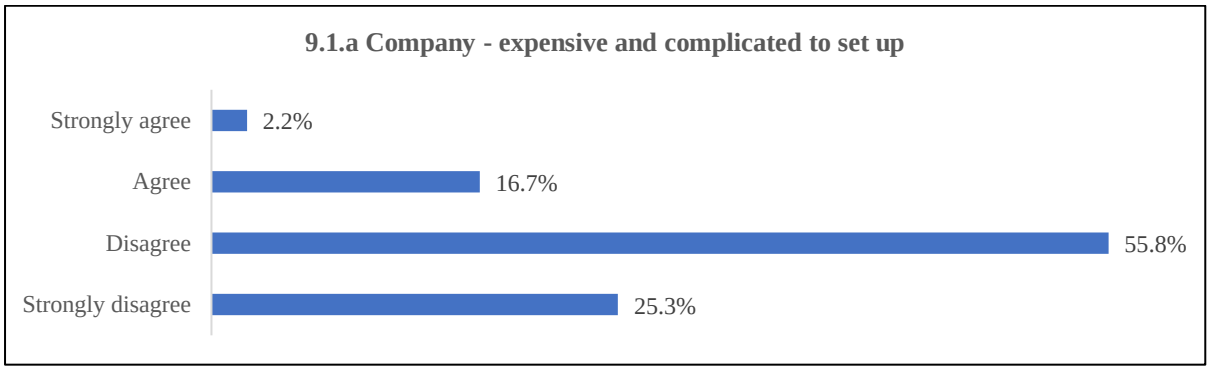
298 Based on the figures contained in the HMRC Reasons Behind Incorporation (n 25) 24.

299 Freedman and Godwin (n 32) 250.

300 Companies (Model Articles) Regulations 2008, replacing the old 'Table A'. For a comparison see: Net Lawman, *Model Company Articles: How Are They Different From Table A,* 2020 <https://www.netlawman.co.uk/ia/companies-house-model-articles> accessed 3 April 2022.

301 68/360.

Figure 46: Agreement that companies are expensive and complicated to set up[302]



The accountants were also invited to report how much they would typically charge an owner-managed business to assist with incorporation and informed that they could provide a range if they felt that this was more appropriate. The question was presented as one with a free text answer to enable the respondents to independently determine the ranges. 296 responses[303] were received, with the ranges below subsequently being superimposed upon the data. The ranges were determined so as broadly to encompass those offered by the accountants themselves meaning that, for the most part, the ranges provided fell within the same price banding. Where the response spanned more than one category, the classification was based upon the mean price.

Whilst a minority of respondents (2.7%)[304] offered the service for free, presumably with a view to securing continuing business[305] or the anticipation/expectation of payment for other

302 0 'don't know' responses received. Cross-tabulated data for qualification, experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

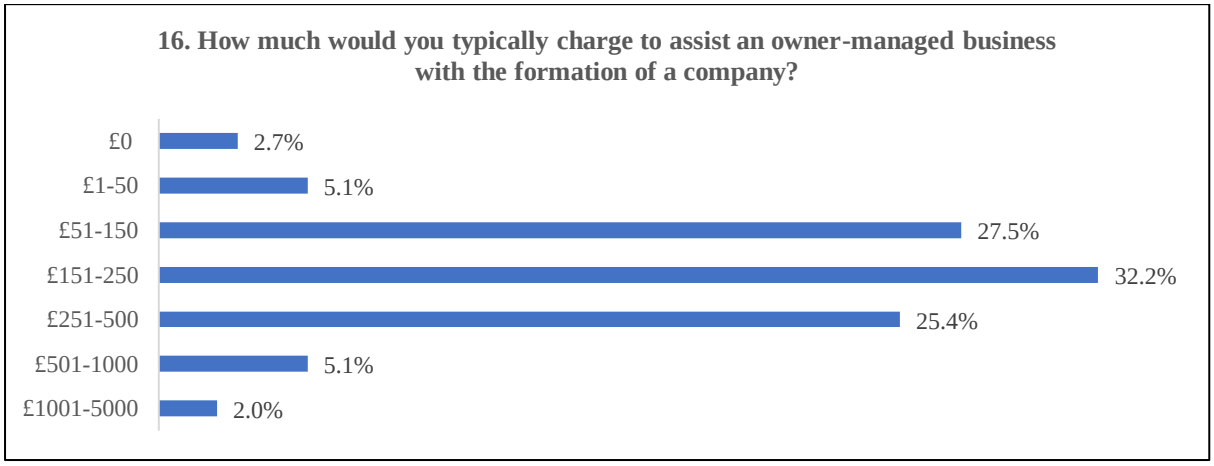
303 Three responses have been removed from the tally on the basis that actual sums were not provided e.g., in one case the accountant did not offer the service to clients.

304 8/296.

305 One respondent expressly stated that this was the case.

services, the median price range for the company formation service was £151-250 (32.2%),[306] that being significantly more than the basic cost of incorporation with the Companies House or formation agents. As can be seen in Figure 47, most quotes (85.1%)[307] fell within the £51-500 price bracket, though 7.1%[308] charged more than £500 for company formation services – it is unclear whether these respondents assumed that a bespoke package would be offered.

Figure 47: Price charged to assist an owner-managed business with incorporation



A comparison with the partnership data on this point produces interesting results. 80.5%[309] of the respondents agreed that ease of set up was a significant advantage of the partnership form, thereby ranking highest in the list of perceived partnership advantages. However, Chartered Accountants were significantly more likely to believe that the partnership was not easy to set up; 22%[310] disagreed with the proposition that it was easy to set up.

306 95/296.

307 251/296.

308 21/296.

309 285/354.

310 55/250.

Figure 48: Agreement that ease of set up is an advantage of the partnership[311]

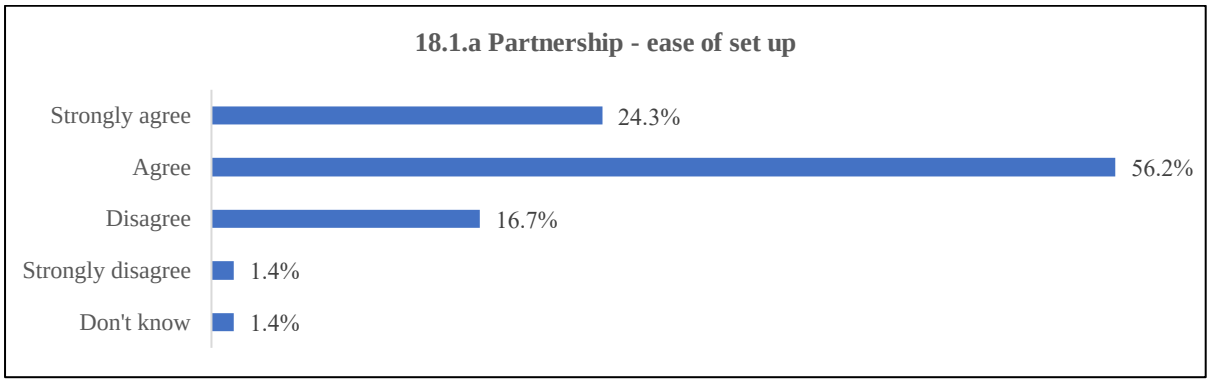
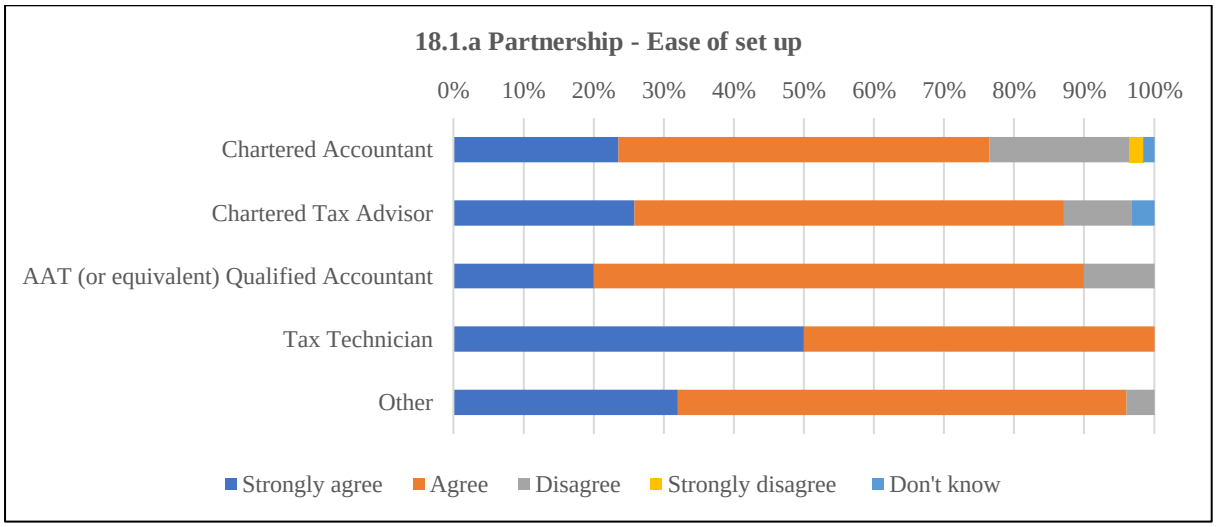


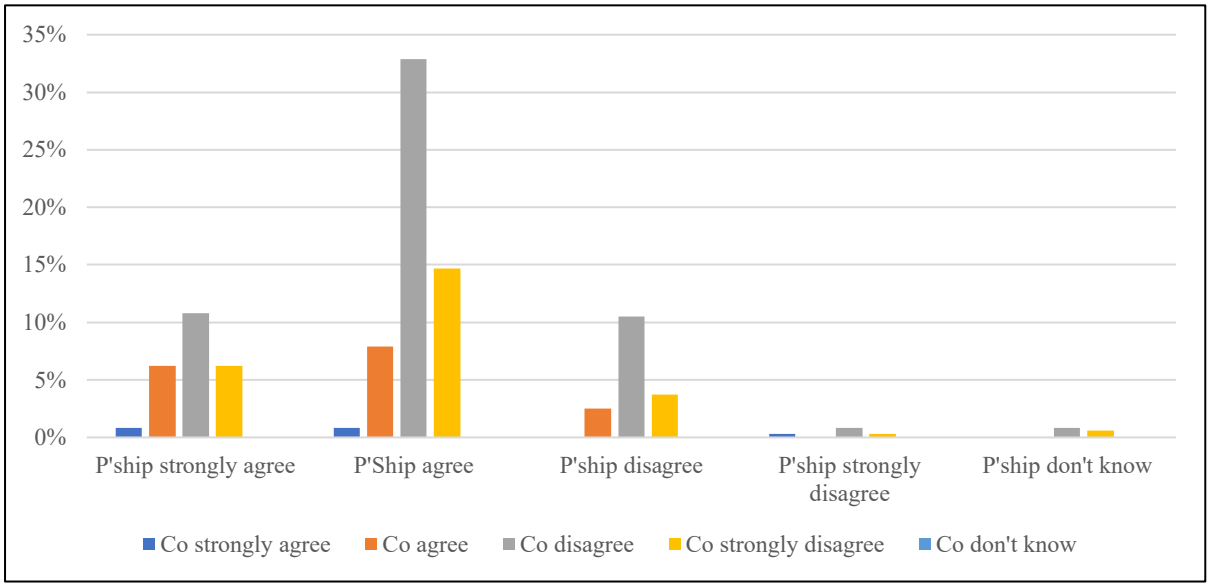
Figure 49: Agreement that ease of set up is an advantage of the partnership, by reference to qualification



Cross-tabulated with the data in relation to companies, the general view appears to be that both forms are easy to set up for owner-managed businesses.

311 Cross-tabulated data for experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Figure 50: Agreement that the company is expensive/complicated to set up and that the partnership is easy to set up



The picture becomes more complex when the process and costs of drafting a partnership agreement are considered.[312] Inherent in this process is the risk of human error which may lead to conflicting provisions, ambiguity and ultimately litigation.[313] 4/24 of the free text responses indicated a concern that a number of owner-managed businesses operate without one, but as previously discussed this is not advisable.[314] When questioned in relation to the complexity and expense involved in drafting a comprehensive partnership agreement, the significant

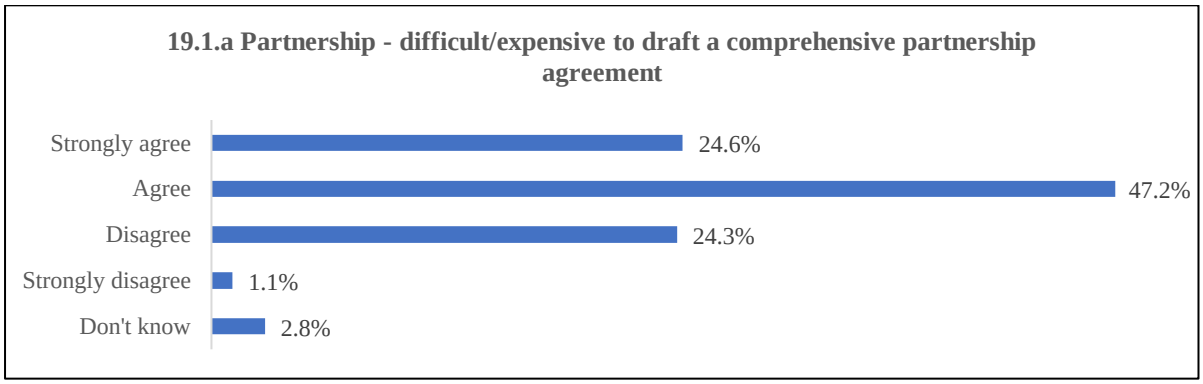
312 Lindley and Banks (n 164) 10-13: 'It would be virtually impossible to draft an agreement which regulates every aspect of the partnership relation, and this was clearly recognised by Lord Lindley when he observed that partnership agreements: "are not intended to define, and are not construed as defining, all the rights and obligations of the partners inter se. A great deal is left to be understood."'

313 Leo Striner and Travis Laster, 'The Siren Song of Contractual Freedom', in Robert Hilman and Mark Loewenstein, *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations* (Edward Elgar Publishing 2015).

314 One linked this to cost: 'Often owner managed businesses do not have a partnership agreement drafted due to cost (which can cause uncertainty in the future).'

majority (71.8%)[315] tended towards the view that this was a disadvantage of operating in partnership (ranking fourth in the list of five proposed disadvantages).[316]

Figure 51: Agreement that expensive/complicated to draft a comprehensive partnership agreement[317]



The Chartered Accountants were most likely across the qualification groups to view the drafting process as complicated and expensive (75.2%[318] agreed that it was a disadvantage of adopting the partnership form). By way of contrast, the Chartered Tax Advisor respondents – in possession of an equivalent level of qualification - were in fact the least likely to report that the drafting process is complicated and expensive (38.7%[319] disagreed with the proposition in the question) (Figure 52), though interestingly they were also least likely to have conducted the drafting task on behalf of an owner-managed business client (Figure 54). Tax Technicians

315 254/354.

316 One respondent believed that this could be mitigated by the use of simple templates and by encouraging owner-managers to not make the arrangements overly complex. 'The simple form partnership agreement can be quite clear on the dissolution and break up rights and continuation past death.'

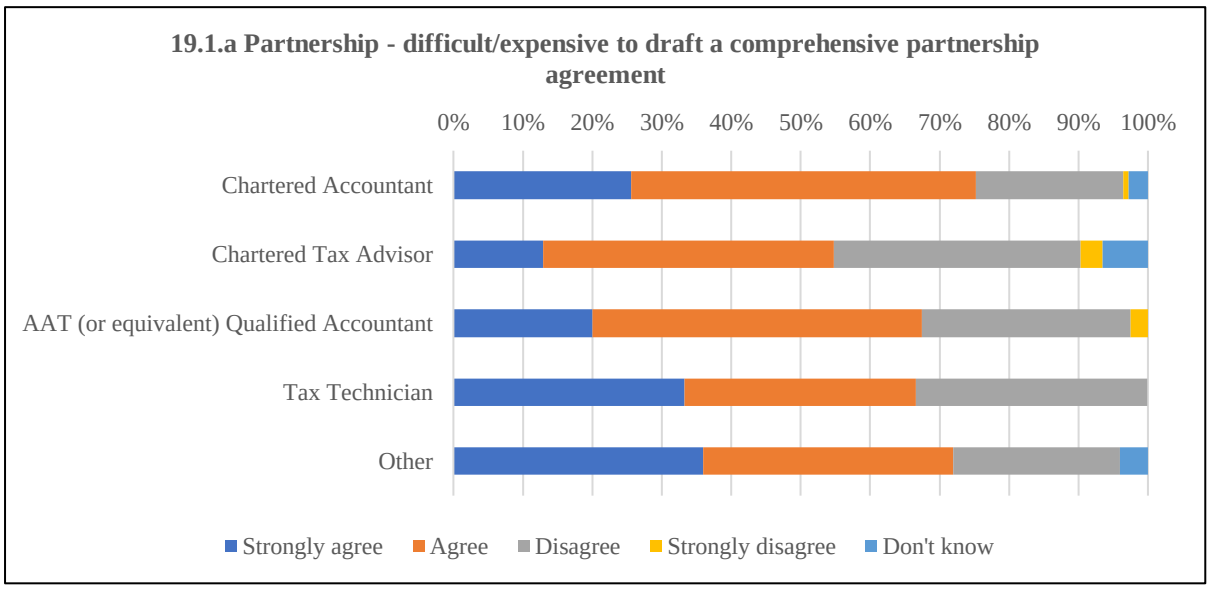
317 Cross-tabulated data for experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

318 188/250.

319 12/31.

were most likely to have previously drafted a partnership agreement (50% had),[320] though the response numbers for this group are very low (just 4 were received).

Figure 52: Agreement that expensive/complicated to draft a comprehensive partnership agreement, by reference to qualification



The cost issue is also manifest in the responses pertaining to the amount charged to assist with drafting a partnership agreement. 31.5%[321] of those who provided a response to the question in relation to costs stated that this is a task that would be referred to a lawyer, rather than done in house.[322] It is then not too surprising that only 18.4%[323] of the respondents said that they had previously drafted a partnership agreement on behalf of an owner-managed

320 2/4.

321 17/54.

322 Two expressed the incorrect view that this is a reserved legal activity.

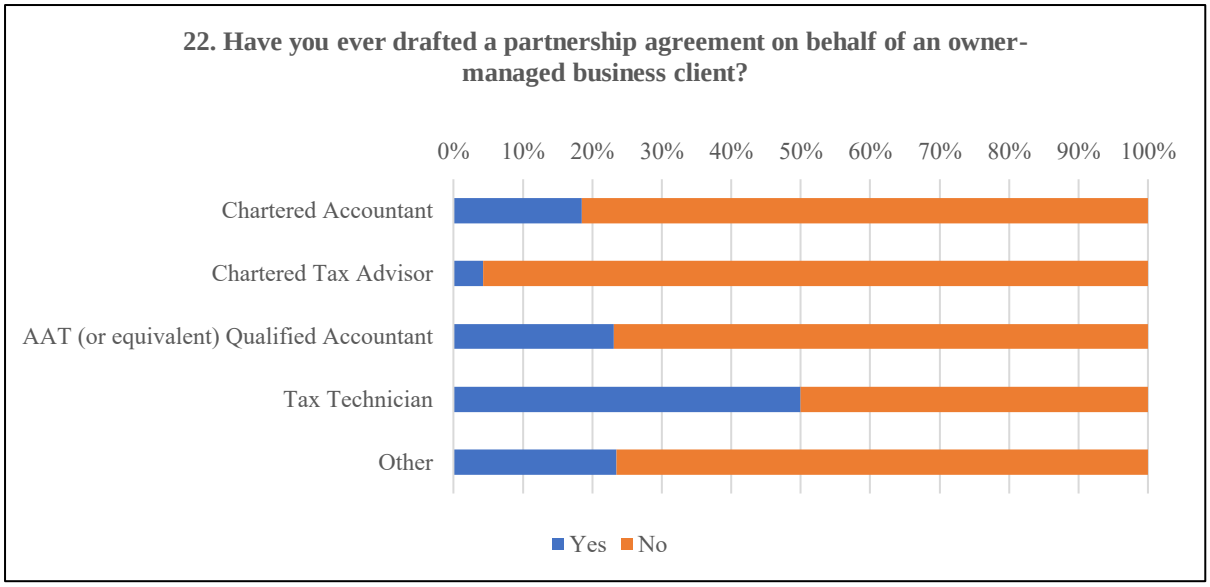
323 49/266. The number of nil responses on this question was high.

business client. Interestingly, across the experience-based groups, the least experienced were most likely to have undertaken the drafting task (30% had)[324] (Figure 55).

Figure 53: Percentage of accountants that have drafted a partnership agreement on behalf of an owner-managed business client[325]



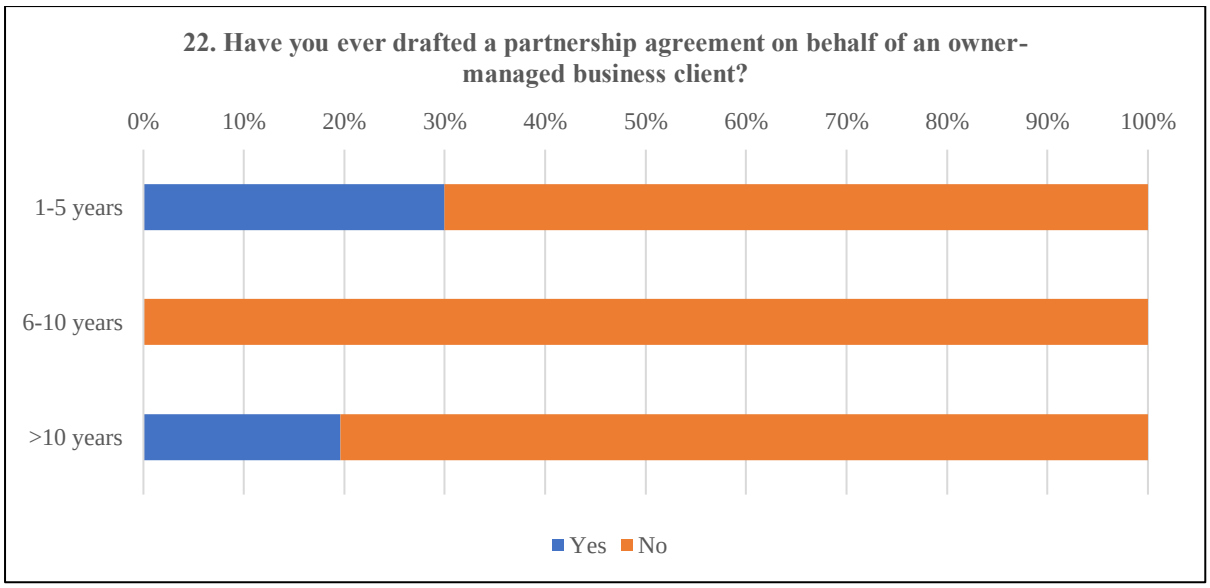
Figure 54: Percentage of accountants that have drafted a partnership agreement on behalf of an owner-managed business client, by reference to qualification



324 3/10.

325 Cross-tabulated data for firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Figure 55: Percentage of accountants that have drafted a partnership agreement on behalf of an owner-managed business client, by reference to experience



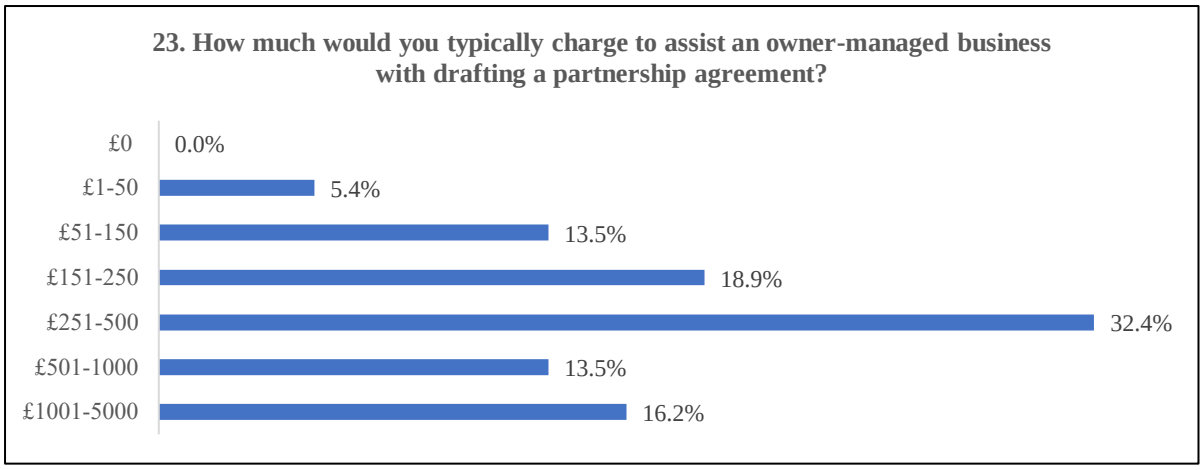
Where cost figures were provided by those willing to offer the service,[326] and aggregated in the same way as the company data, it becomes apparent that the typical costs associated with drafting a partnership agreement are higher than those for the formation of company; the median price range here was £251-£500 (32.4%),[327] no accountants were willing to offer the service for free, and 29.7%[328] would charge more than £500 to draft a partnership agreement (22.6% higher than those charging the same for the formation of a company).

326 One provided an estimate but said that it had not been a service requested of him/her in the past. It should also be noted that since the question only generated 37 responses, as compared to 299 for companies, the statistics are likely to be less reliable on this point.

327 12/37.

328 11/37.

Figure 56: Price charged to assist an owner-managed business with drafting a partnership agreement



It is likely the case that the complexity and costs of forming a company today are overstated or are certainly less of an issue than they have previously been. That being said, it is still also true that the partnership is the easier entity to form, though also likely the most costly if done properly, with a comprehensive agreement. That makes a comparison on this point more difficult than others contained in this Chapter. Put simply, one form – the partnership - is easier to set up, and the other – the company – is cheaper to set up. In this respect, neither form has the clear advantage over the other, unless one is willing to operate without a partnership agreement in place.

2.3.3 Lack/Loss of Privacy

'On the basis that "forewarned is forearmed" the fundamental principle underlying the Companies Acts has always been that of disclosure.'[329] Freedman and Godwin explored the possibility that lack of confidentiality (privacy) might be a drawback of incorporation. They

[329] Gower (n 30) 765.

found that 50.4% of their respondents agreed with this suggestion; it thereby ranking third highest on the list of prompted disadvantages.[330] The HMRC Reasons Behind Incorporation Report also noted that 50% of their respondents 'agreed that they would have preferred it if information about their company was not publicly available.'[331] A respondent to the qualitative interview expressed the view that not only did the publication of information feel intrusive, but she also had not anticipated this at the point of incorporation.[332] This desire for privacy conflicts with the increasing public demand for transparency in the operation of corporate entities (this also serves to benefit any potential creditors). Whilst one of the accountants returning the author's survey indicated that '*[p]rivacy does not tend to be a factor, as whilst sole trader there can be the same lack of privacy too*,' those operating through the company form are obliged to make certain information public, which is not the case for sole traders and partnerships. A quick search on the Companies House website[333] generates information relating to the directors and officers of the company, company shareholders, any persons with significant control, the articles of association[334] and access to the company accounts. The personal information, at the very least, provides the names and correspondence addresses of the aforementioned individuals, but also often includes a date of birth, nationality and occupation. If the business owns or rents premises then owner-managers could avoid making their home address public by setting the business address as the correspondence address, but this will not always be possible (nor is it an option always taken where it is available) such as when the business is

330 Freedman and Godwin (n 32) 250.

331 HMRC Reasons Behind Incorporation (n 25) 60.

332 HMRC Reasons Behind Incorporation (n 25) 60.

333 GOV.UK, *Find and Update Company Information* <https://find-and-update.company-information.service.gov.uk/search/> accessed 3 April 2022.

334 The effects of this can be mitigated by omitting sensitive information from the articles, and instead proceeding by way of shareholder agreements, which would remain private.

home-based; this will often be the case for those operating in the construction industry or other 'moving trades'.[335] Whilst, as observed above, most owner-managed business will be able to provide the Companies House with short unaudited financial statements,[336] the level of disclosure will still likely be sufficient for any competitors to gain an understanding of the current financial position of the business – a less than ideal position.[337] Furthermore, with the increasing prevalence of cyber-crime, concerns have been expressed about the ability of fraudulent persons to make use of Companies House information. The available data can suffice for the acquisition of credit cards[338] and there is evidence to suggest that the ease of changing director and shareholder details with the Companies House has previously resulted in the business itself being stolen.[339]

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335 Individuals can request that the Companies House remove a personal address from publicly available documents, by way of application at the cost of £32. However, this is only where the address is not used as the company's registered office or place of business. See Companies House, *Your Personal Information on the Companies House Register,* 2019 <https://www.gov.uk/guidance/your-personal-information-on-the-public-record-at-companies-house#how-the-public-can-access-information> accessed 3 April 2022.

336 CA 2006, s 477. One accountant noted 'smaller companies have privacy as the filleted [sic] accounts disclosure is limited.'

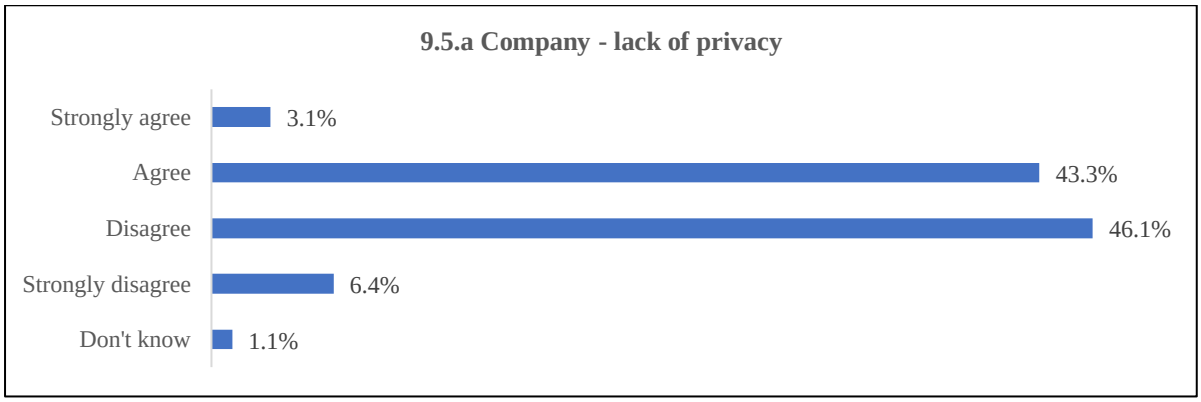
337 One respondent to the author's survey noted this as a concern: 'the balance sheet of the company is public so competitors can see the liquidity of the business.'

338 See, for example, Moore Barlow LLP, *Can I Remove Personal Information from Companies House?,* March 2022 <https://www.moorebarlow.com/can-i-remove-personal-information-from-companies-house/> accessed 20 March 2022: ' We recently acted for an individual who had an unsolicited delivery of clothes from a well-known clothes store. He thought this was strange because not only had he not made an order, the parcel contained only ladies clothes. He almost thought nothing of it, but eventually decided to contact the clothes store to query it. After a series of very long and frustrating telephone calls, it transpired that a credit account had been set up in his name for £2,000 of credit and a series of transactions had been undertaken in his name. To achieve this, all that had been required was his name, date of birth and home address. This individual has several appointments at Companies House and if you know where to look, his full date of birth and home address was available on documents which are easily available to download, free of charge.'

339 Duport, *Protect Your Business Against Corporate Identity Theft,* December 2006 <https://www.duport.co.uk/guides/business-protection/corporate-identity-theft.php> accessed 20 March 2022.

46.4%[340] of the accountants responding to the author's survey agreed that the lack of privacy was a significant disadvantage of operating through the company form, though again the respondents had a split opinion on this point. This question, as with the others in the survey, specifically addressed this in the context of an *owner-managed* business, so this view was formed notwithstanding the reduced amount of information demanded by the Companies House. On this matter, the respondents possessing 'Other' qualifications were most positive about the company form; 72%[341] reported that lack of privacy is not a disadvantage of the form (Figure 58).

Figure 57: Agreement that lack of privacy is a disadvantage of the company[342]

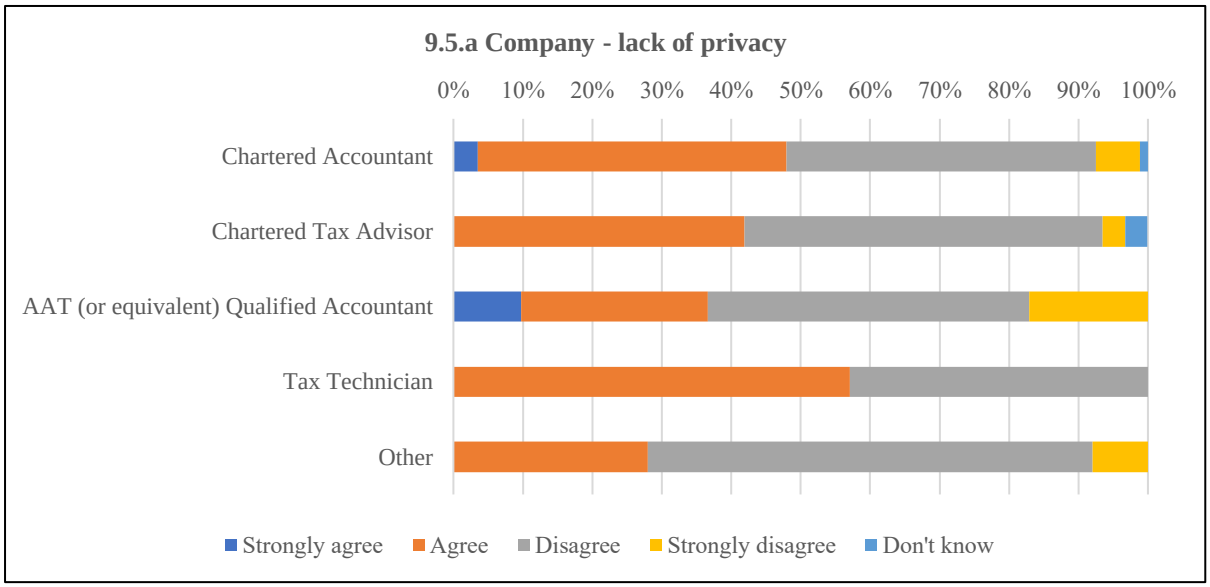


340 167/360.

341 18/25.

342 Cross-tabulated data for experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Figure 58: Agreement that lack of privacy is a disadvantage of the company, by reference to qualification



Once again, the respondents were much more inclined to agree that the levels of privacy the partnership offers is an advantage associated with the form; 26%[343] even strongly agreed that this was the case, with a further 53.4%[344] agreeing (79.6%[345] total) (Figure 59). Interestingly, the 'Other' qualified accountants were also most positive about partnership privacy (84%[346] agreeing that it is an advantage of the form), though to an even greater extent than the company (Figure 60).

343 92/354.

344 189/354.

345 281/354.

346 21/25.

Figure 59: Agreement that privacy is an advantage of the partnership[347]

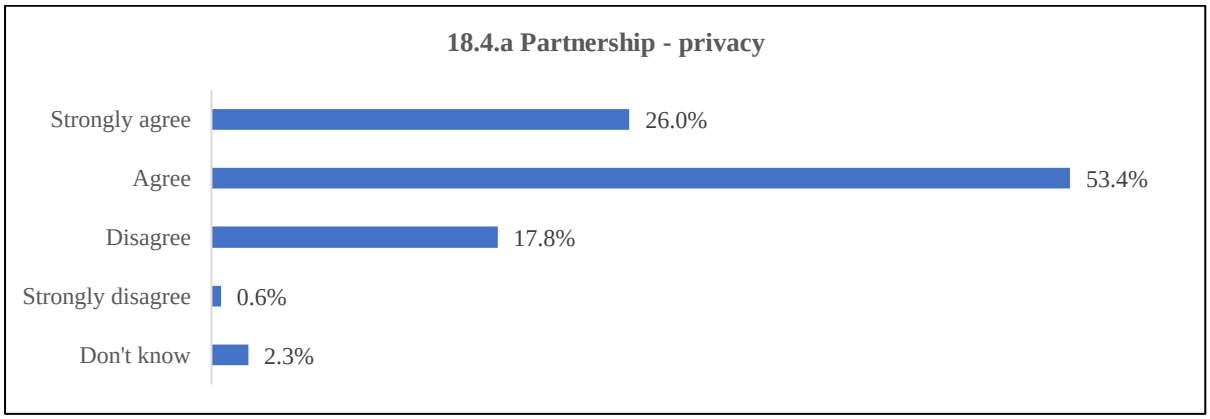
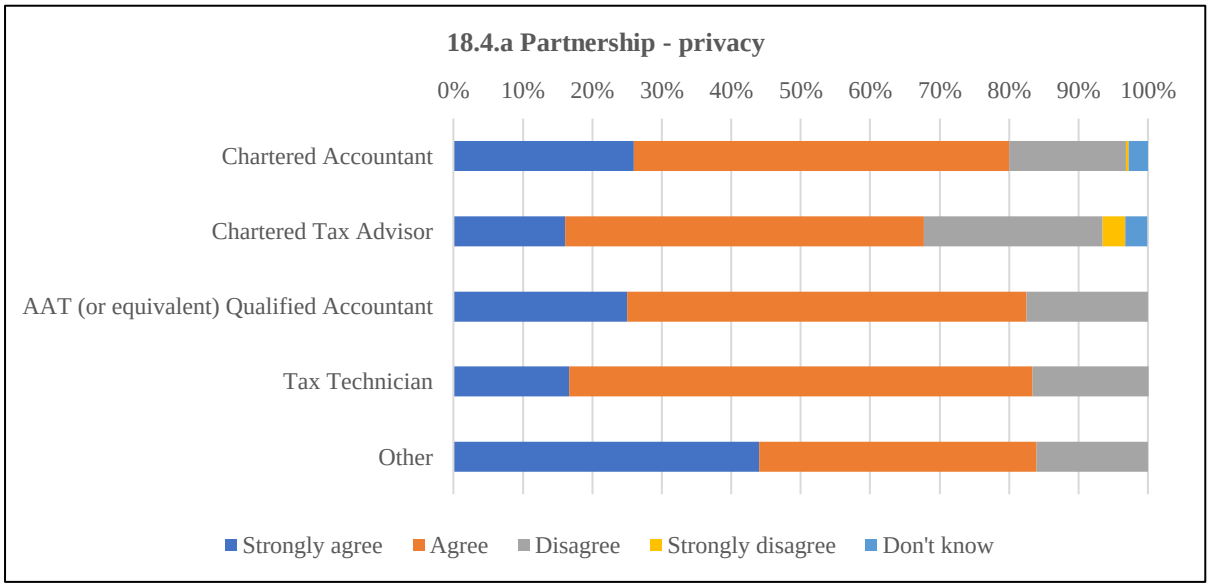


Figure 60: Agreement that privacy is an advantage of the partnership, by reference to qualification

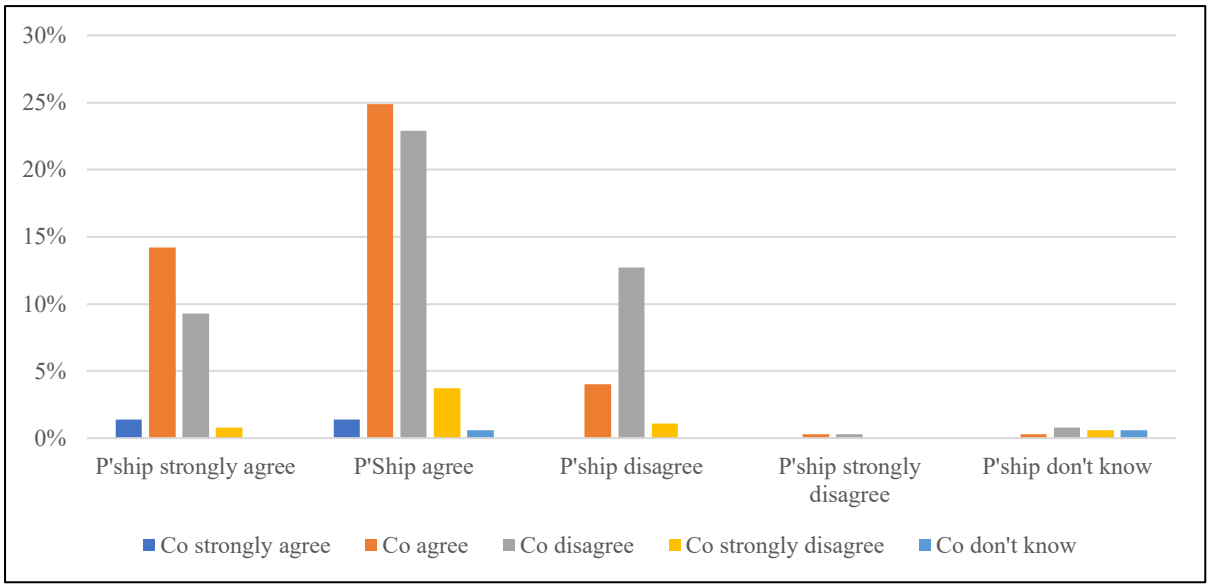


41.9%[348] of the respondents indicated that lack of privacy was a disadvantage of the company, but the levels of privacy associated with the partnership were an advantage of the form (Figure 61).

347 Cross-tabulated data for experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

348 148/353.

Figure 61: Agreement that lack of privacy is a disadvantage of the company and that privacy is an advantage of the partnership



Overall, this data serves to support the hypothesis that if privacy is of concern to the owner-manager, then all else being equal, it is the partnership that is the more satisfactory form for doing business.

2.3.4 Flexibility of Business Structure

All companies must have at least one shareholder, a director, a memorandum of association and articles of association registered at the Companies House. The need for the articles of association means that from the outset owner-managers must have accounted for the directors' powers and responsibilities, the company decision making procedures, shares and distributions. Whilst the model articles provided by The Companies (Model Articles) Regulations 2008[349]

[349] SI 3229/2008.

make this process relatively easy, the problem arises when changes need to be made, such as where the model articles subsequently prove unsuitable.

As is the case for the initial incorporation of a company, there are prescribed formalities and Companies House filing obligations that attach to any changes to the company articles of association, company shareholders[350] and directors.[351] By way of example, in order to change the company articles of association, section 283 CA 2006 requires that there be a legitimate reason for making changes and that there be a special resolution, requiring at least 75% of the total shareholder votes. However, neither of these need cause an owner-managed company too much of a practical problem; the requirements will typically present themselves in the form of an additional compliance burden. A copy of the resolution and the new articles of association must then be filed with the Companies House within 15 days. This will be necessary to effect any changes to the internal governance structure of the company but will also be relevant where the existing articles of association do not permit a share buyback, which will be needed to correct the perennial problem of owner-managed companies incorporating with excessive share capital (assuming there is a desire to fix the issue).[352] In the latter case, the register of shareholders will also need to be updated.

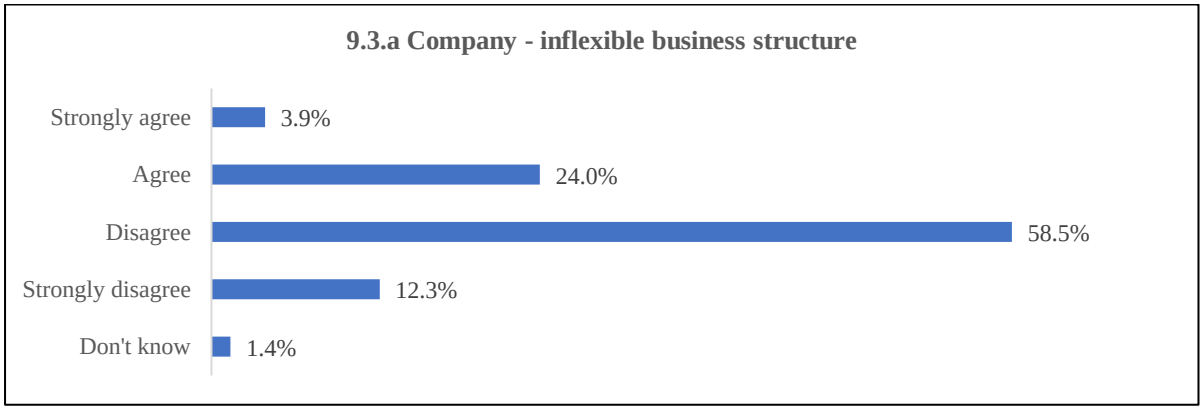
350 This can be done on the annual confirmation statement, but an up-to-date register of members must be kept and be available for inspection at all times (CA 2006, Pt 8A, Ch 2). The same applies to persons with significant control (s 790M-N).

351 CA 2006, s167. CA 2006, s 267 applies to changes in company secretaries, where there are any, though there is no requirement to have a secretary (CA 2006, s 270).

352 OTS Small Company Taxation Review (n 40) 78. CA 2006, Ch 10 makes detailed provision for the regulation of share buy backs. Of note is s 643 which provides that a solvency statement will also need to accompany the special resolution in this case. However, this course of action may generate capital gains tax charges ("**CGT**") for the shareholders, even where no consideration is paid.

Notwithstanding the above, the accountants responding to the author's survey decidedly rejected the proposition that the company provided an inflexible business structure; 70.8%[353] indicated disagreement.

Figure 62: Agreement that inflexible business structure is a disadvantage of the company



This strong level of disagreement may be attributable to the fact that the model articles of association can be amended at the point of incorporation, to suit the needs of the business, and/or because the formality requirements associated with subsequent amendments do not *per se* affect the flexibility of the structure – after all, it is possible to make changes – but simply increase the costs of making changes.

There are slight variations if the data is cross-tabulated on the basis of qualification (Figure 63), experience (Figure 64), and firm size (Figure 65), though it is only in respect of experience that there are correlative results. Generally, the more time the accountant had spent in practice the more likely they were to disagree that the company is an inflexible business structure, suggesting that increased exposure to the form leads to an overall more positive view.

353 254/359.

Figure 63: Agreement that inflexible business structure is a disadvantage of the company, by reference to qualification

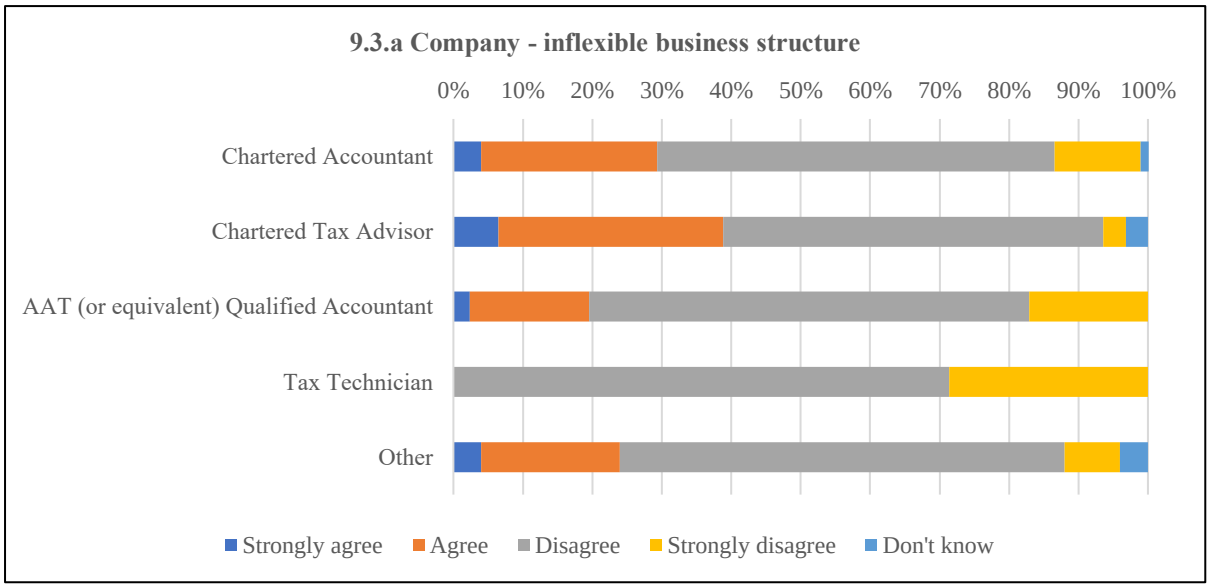


Figure 64: Agreement that inflexible business structure is a disadvantage of the company, by reference to experience

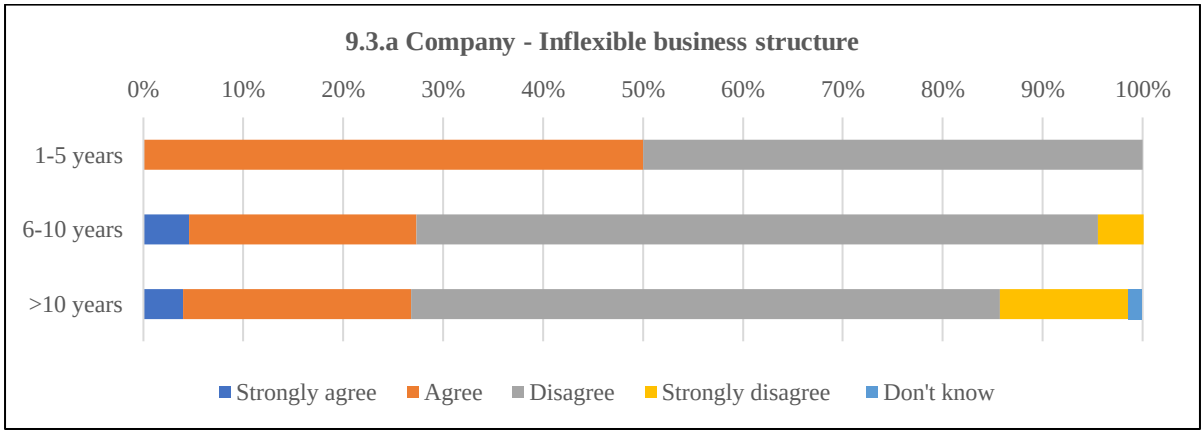
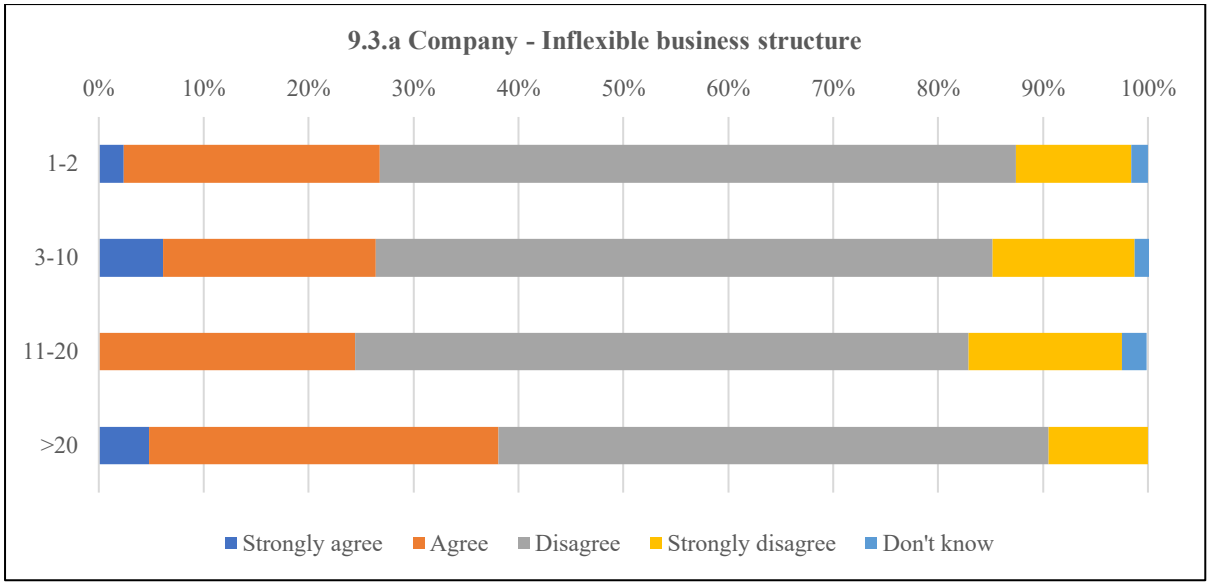


Figure 65: Agreement that inflexible business structure is a disadvantage of the company, by reference to firm size



Turning to the partnership, the associated flexibility is frequently touted as one of its most significant advantages.[354] Indeed, whilst it is not advisable, there is no formal requirement

354 And not necessarily just for small businesses, McCahery and others (n 40) 45: '[w]hile there is great appeal to the utilisation of existing frameworks, firms are more inclined to structure their business in a framework that is largely free from oversight and allows experimentation.'; Joesph McCahery, Erik Vermeulen and Priyanka Pridershini, 'A primer on the uncorporation', European Business Organization Law Review (2013) 310: 'Corporation law does not have partnership-like flexibility and generally does not provide shareholders with the same kind of freedom to vary from statutory provisions….In practice, lawyers often struggle to translate the shareholders' wishes into a comprehensive set of articles of incorporation. In the case of a conflict between partners, provisions of the statute and the articles are likely to override the terms set forth in the joint venture agreement. The upshot is that such conflicts may dilute the value of a joint venture agreement upon incorporation. To encourage joint ventures, a limited liability vehicle that is truly flexible in formation, organisation and control of the venture is an effective option since it holds out the potential to limit risk and deliver cost-saving benefits.' And, later at 311: 'it could be argued that policymakers should concentrate their resources on developing flexible uncorporate forms that better enable families to embrace governance strategies which promote their long-term success irrespective of the stages of business development. Not only will improved governance provide a more effective means to deal with family matters that affect business, it may also free up managerial resources that are necessary to run the business well, and thereby enable capital-intensive work to remain in a country.'

Of course, there is the possibility that some businesses do not want flexibility: Vanessa Finch and Judith Freedman, 'The Limited Liability Partnership: Pick and Mix or Mix-Up?' (2002) Journal of Business Law, 475, 498.

in the law for there to be a partnership agreement.[355] The malleability of the financial and constitutional provisions is deemed to be particularly beneficial where start-ups and, crucially, owner-managed businesses are concerned.[356]

> Comparing the Partnership Act to the Companies Act…demonstrates another facet of the 1890 Act. It is on the whole a voluntary code. Section 19 allows all its provisions as to the rights and duties of the partners vis-à-vis each other to be varied by consent, express or implied. Other sections are also subject to contrary intention. This feature can be attributed to the contractual nature of the partnership. As with other contracts the parties can, within certain defined limits, agree to whatever terms they wish as between themselves…
>
> Turning from the Partnership Act 1890 to the Companies Act 2006 is to experience the culture shock of the time traveller. Like man and apes they are cousins, but the relationship is sometimes difficult to imagine…[357]

This 'voluntary code' or 'laissez-faire regime'[358] contained in the Partnership Act 1890 ("**PA 1890**") makes it easier for those operating in partnership to respond to the 'need to overcome the legal, commercial, and often, social difficulties' involved in business relationships,[359] including the need to amend the business structure or the balance of responsibilities and/or profit allocations between partners.[360] This can easily be done by simple

---

355 Where there is no partnership agreement, the relationship between partners is governed by the default provisions contained in the PA 1890 and the general law. See Morse (n 12) 180-206.

356 4 free text responses to the author's survey noted that the partnership form could be advantageous for start-up businesses, especially where likely to be unsuccessful. This is echoed by Paul Howard and Paula Tallon, *Tolley's Tax Planning for Owner Managed Business* (Lexis Nexis 2017) 6; John Pointon and Derek Spratley, *Principles of Business Taxation* (OUP 1988) 307. Historically, the ordinary partnership had been a popular business form for larger, often professional, partnerships, Morse (n 12) 2: 'Until the advent of the limited liability partnership, partnership remained the preferred medium for professions, initially due the flexibility of financial and constitutional provisions when compared with a company…'.

357 Morse (n 12) 11.

358 Geoffrey Morse ed., *Palmer's Company Law* (Sweet and Maxwell, January 2018) 0.2.24: 'The bad news for directors is statutory perturbation; the legislative climate for companies is strict and getting stricter, in stark contrast to the laissez-faire regime for unincorporated partnerships.'

359 Martin Edhouse, *Tolley's Tax Guide 2016-17* (Lexis Nexis 2016) 2069.

360 Rayney (n 68) 27.7, lists the loss of flexibility as a result of incorporation as a potential commercial disadvantage. 14 out of the 35 free text responses in relation to partnership advantages in the survey

oral agreement or understanding, in accordance with contractual principles, though once again it would be advisable to make a written record of any agreement. Unfortunately, there is a real risk that when friends or members of a family do business together there will be (sometimes emotionally fuelled) disputes: 'a friendship founded on business is a good deal better than a business founded on friendship'.[361] In family businesses, the reality of overlapping values must be addressed. What is technically an employer-employee relationship may also constitute a husband-wife or parent-child relationship. Where there is conflict, determining which relationship ought to take precedence is inherently difficult; to this extent many owner-managed businesses have an inbuilt conflict from the start.[362] Once more, the inherent flexibility of the partnership agreement makes it easier for a partner to exit, or for the partnership to cease, where there are irreconcilable differences between partners (such as when spouses separate).

The survey responses confirmed that the partnership is regarded as a flexible form, which is no doubt an advantage considering the previous observations; overall, 80.5%[363] agreed that it was a flexible business structure (Figure 66). This is also 8% higher than the percentage of accountants who expressed the view that the company is a flexible business form. Accountants based in the largest firms (more than 20 accountants) were most optimistic about the benefit of partnership flexibility (Figure 68).

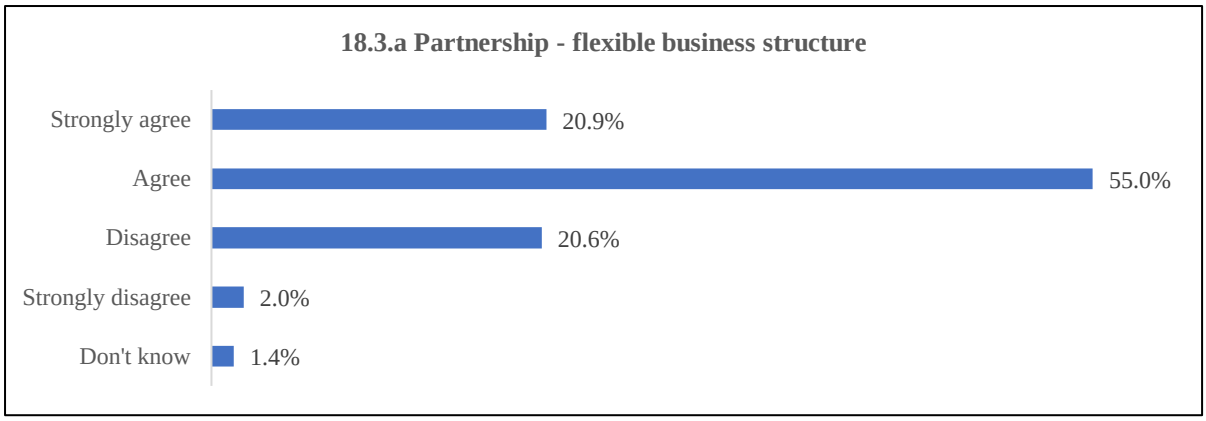
indicated that flexibility, mainly in relation to profit sharing, was a significant advantage of operating as a company.

361 The HMRC Reasons Behind Incorporation Report (n 25) notes that 62% of the respondent companies that had more than one director said that at least one of the other directors was a family member – in total 21% of companies had director shareholders that were part of the respondent's company.

362 Means (n 147).

363 285/354.

Figure 66: Agreement that flexible business structure is an advantage of the partnership[364]



However, at least a quarter of the Chartered Accountants (25.2%)[365] and AAT (or equivalent) qualified accountants (25%)[366] did not think that partnership flexibility is a significant advantage (Figure 67). Members of the largest first were overall the most inclined to believe that it is (Figure 68).

364 Cross-tabulated data for experience has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

365 62/246.

366 10/40.

Figure 67: Agreement that flexible business structure is an advantage of the partnership, by reference to qualification

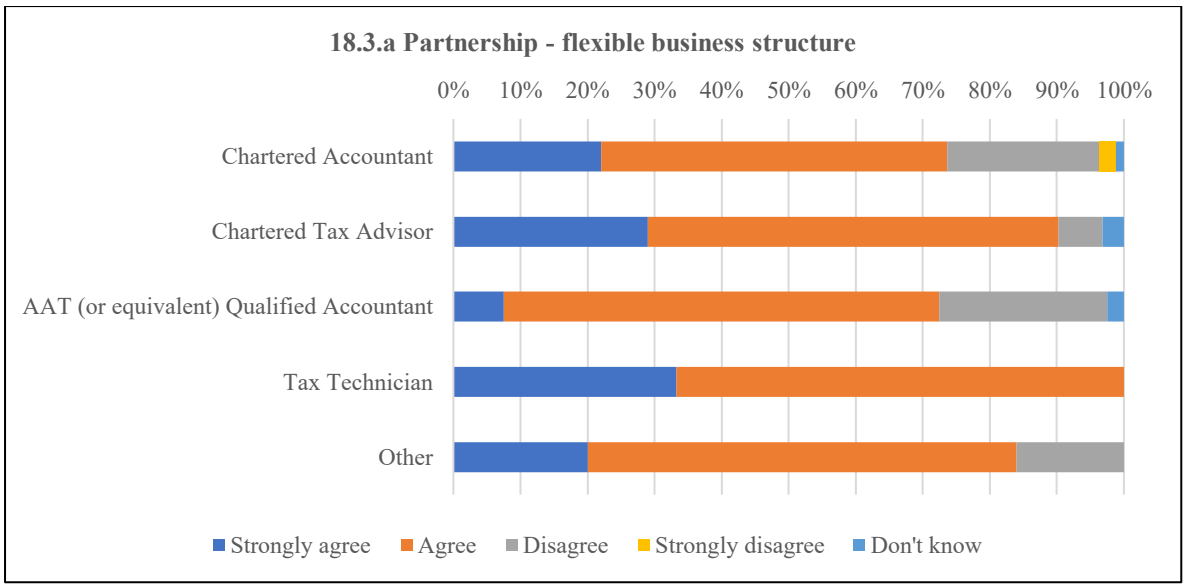
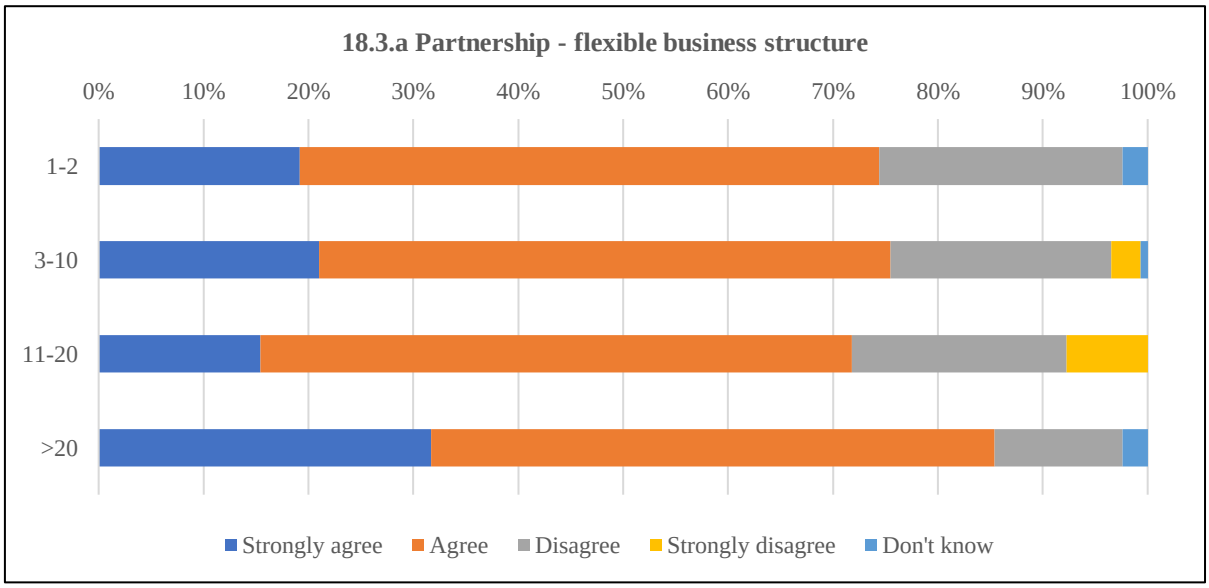
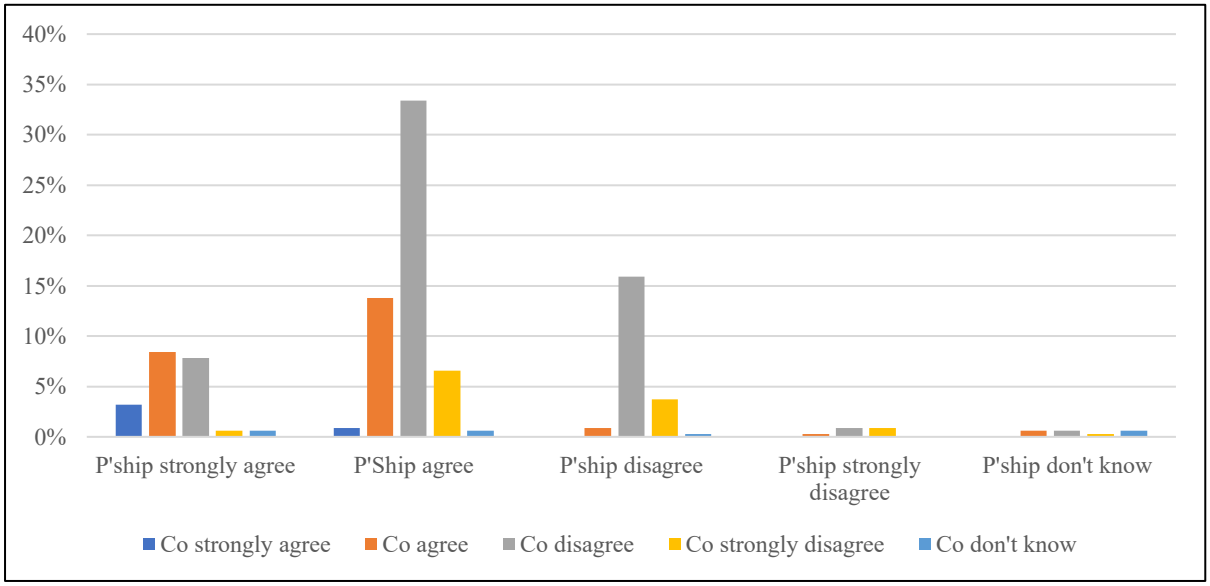


Figure 68: Agreement that flexible business structure is an advantage of the partnership, by reference to firm size



In light of the fact that the respondents were disinclined to think that the company is an inflexible form, it makes perfect sense that when the answers between the questions in respect of flexibility are cross-referenced, there is no correspondence in the relative advantages/disadvantages on this point. It transpires that the majority (48.4%)[367] of respondents agreed that both forms were flexible.

Figure 69: Agreement that inflexible business structure is a disadvantage of the company and that flexible business structure is an advantage of the partnership



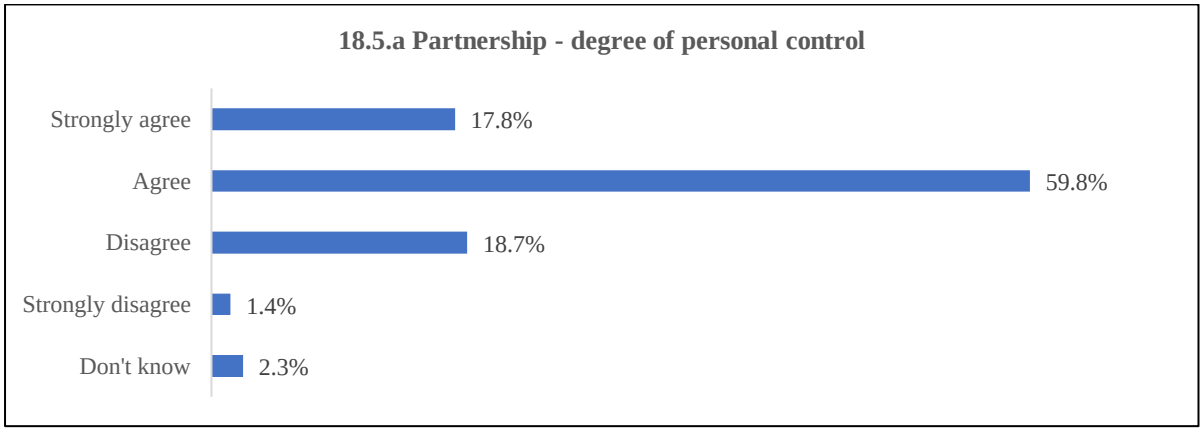
The inherent flexibility of the partnership generates one further benefit, namely, that at all times a high degree of personal control is retained over the running of the business and the management of its assets with no need to account to the Companies House. A small number of firms responding to Freeman and Godwin's survey (11.2%) thought that loss of personal control and loss of control over capital were possible disadvantages of incorporation.[368] It is

367 168/347.

368 Freedman and Godwin (n 32) 250.

likely that this is attributable to the administrative burdens attaching to any significant changes in the way the business is conducted. The author's survey results confirmed the view that partners in owner-managed businesses do indeed retain a high degree of personal control; 77.6%[369] agreed that this was an advantage. This ranked third in the list of proposed advantages.

Figure 70: Agreement that degree of personal control is an advantage of the partnership[370]



Based on the above, it seems reasonable to conclude that both the company and the partnership are properly regarded as business forms capable of offering a sufficient degree of flexibility for owner-managed businesses, though the partnership does seem to have the edge in this respect, especially if the degree of personal control is an added consideration. Crucially, it is another respect in which the company does not appear to offer any significant advantage over and above the partnership. Given the need for flexibility in such business arrangements, there is no justification for abandoning the partnership here.

369 211/353.

370 Cross-tabulated data for qualification, experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

2.3.5 Dissolution and Disincorporation of the Company

There are three main circumstances in which the owner-manager may decide that dissolving the business is commercially necessary: firstly, if the business structure turns out to be unsuitable and an unincorporated form would be preferable (disincorporation); secondly, where the owner-manager chooses to cease trading such as where the business is unprofitable or the owner-manager has decided to retire; thirdly, where irreconcilable differences between owner-managers mean that the company needs to be dissolved. All are reasonably foreseeable events in the course of business. As previously observed, the success rates in the owner-managed business world are low, and the possibility of conflict high. Accordingly, if owner-managers are 'locked in' to the company form, and dissolution/disincorporation is difficult, this has to be seen as a considerable disadvantage.

Unfortunately, there are once again formalities to comply with, and costs to pay, if one proceeds down the dissolution/disincorporation route. The following is a simplified account of the process involved.[371] In terms of dissolution of the company, this can take place in one of two ways:

> *Dissolution and striking off* – Following the transfer (or distribution) of the business and assets to its shareholders, the company can apply to be struck off the register at the Companies House and dissolved. This process is often referred to as 'informal winding up', although there is strictly no winding up as such…
>
> *A formal winding up* – In this case, the disincorporation takes place as part of the formal winding up process through which a liquidator is appointed and distributes the assets to the shareholders and then dissolved.[372]

371 For a detailed account of the winding up process see Palmer's (n 56) Chapter 15.

372 McLaughlin and Anderson (n 124) 437.

For an informal winding up, the company must have ceased trade for at least three months before applying to the Companies House for striking off.[373] Following the application, a notice is placed in the London Gazette[374] and there is a further three-month waiting period during which any objections to striking off can be made – in practice this would usually be creditors. The process therefore takes at least 6 months, during which the director(s) is still responsible for complying with the obligations imposed upon them by the CA 2006, which includes a responsibility for the payment of creditors.

A formal winding up may be done on a solvent or insolvent basis and is regulated by Chapter III, Part IV, IA 1986.[375] This requires the appointment of a liquidator which will typically cost between £5,000 and £7,500 even for a simple liquidation.[376] The liquidator will oversee the dissolution of the business and subsequently apply for striking off.[377] This can be done on a voluntary basis where the company is solvent, so long as accompanied by a statutory declaration of solvency to the effect that the company will be able to pay all of its debts in the

373 CA 2006, s 1003 prevents the company from carrying on any business, changing its name or conducting any other activities except for the settling of debts and conclusion of its affairs in this time period.

374 The Gazette, Official Public Record <https://www.thegazette.co.uk/> accessed 3 April 2022.

375 Palmer's (n 56) 15.002: 'In fact, the two forms of winding-up [voluntary and compulsory] are applicable to solvent and insolvent companies, and it is therefore necessary – even if at first sight somewhat paradoxical – for those who wish to bring about the liquidation and dissolution of a solvent company to refer to the provisions of the IA 1986, and to engage the services of a qualified insolvency practitioner to serve as liquidator of the company. The justification for subsuming both solvent and insolvent liquidations within the same statutory and regulatory framework is essentially so that there can be public confidence in the integrity of the winding up procedure under all varieties of circumstance. If it were the case that the winding up of a supposedly solvent company could somehow avoid the full rigour of the investigative and supervisory procedures that are necessarily applied in the case of an insolvent company, this would give rise to the possibility that in some instances—whether by inadvertence or through calculation—a company that was in reality insolvent might undergo a less exacting procedure through being erroneously classified as solvent at the point of commencement.'

376 McLaughin and Anderson (n 124) 394.

377 McLaughlin and Anderson (n 124) 440: 'A formal winding up involves more formalities and costs (than an informal winding up) but may also provide a more tax-efficient way for the shareholders to disincorporate.'

following twelve months. Once more, until striking off, the duties under the CA Act 2006 are still imposed upon the director(s).

Dissolving and disincorporating businesses will also need to inform HMRC upon the cessation of trade through the company. The tax issues associated with company disincorporation are considered in Chapter 5.

The disincorporation issue was explored by the HMRC Reasons Behind Incorporation study. 7% of the survey participants said that they had disincorporated by the time of the survey, meaning that they were trading for less than three years. The Report adds:

> [t]his increased to 42 per cent for those businesses that had been sold or ceased trading. This finding potentially suggests an element of confusion regarding the concept of 'disincorporating' a business'. Respondents may be incorrectly equating it with ceasing trading or dissolving their business, as opposed to removing the corporate structure and resuming trade as a self-employed individual.[378]

A further 5% of the respondents indicated that they had plans to disincorporate. 'This was higher among companies in administrative and support services (eight per cent). It was also higher among companies with a low turnover (ten per cent of those with a 2012/13 turnover of under £25,000).'[379] This may be taken as another indication that smaller, low turnover, businesses might be best suited to the unincorporated form. Relevant reasons for

---

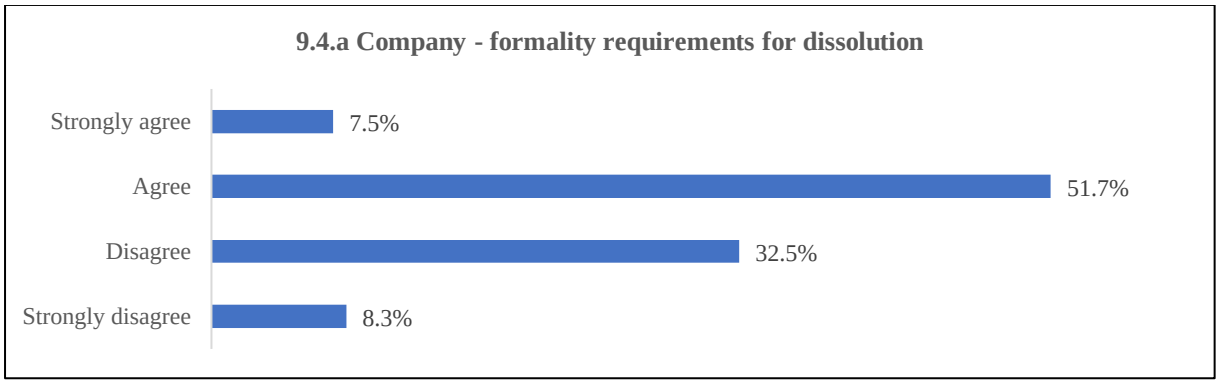
378 HMRC Reasons Behind Incorporation Report (n 25) 63. This is supported by the observations at 64: 'Respondents who claimed to have disincorporated, or were planning to do so, were asked for the reasons. Most commonly, respondents said that the business was declining or being wound down (44 per cent). Nine per cent were going back to a job as an employee and nine per cent were about to retire. These findings further suggest that there may be uncertainty around the concept of 'disincorporation'. This is because in these contexts, individuals might be expected to cease trading rather than removing the corporate structure of their business and continuing as self-employed.'

379 HMRC Reasons Behind Incorporation (n 25) 63.

disincorporation included the complexity of administration in the company form (9%), that being incorporated was no longer relevant to the business model (7%), that incorporation didn't have the expected benefits in terms of growth or sales (5%) or tax savings (4%).

Of the accountants surveyed, the majority (59.2%)[380] agreed that the formality requirements for dissolving a company were a significant disadvantage of adopting the company form.

Figure 71: Agreement that formality requirements for dissolution are a disadvantage of the company[381]



Looking to the 8.3%[382] that strongly disagreed, some respondents were clearly less convinced that the formality requirements were an issue and offered comments such as: '*[d]issolution can be very straightforward if the company is solvent*.' However, another indicated a more nuanced approach, stating that their views were dependent on whether an informal striking off and liquidation was taking place, presumably thinking the latter situation

380 213/360.

381 Cross-tabulated data for experience has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

382 30/360.

involved a much higher administrative burden and cost.[383] It is likely that the former comment also pertained to the informal winding up process, as does another received indicating that it '*can cost just £10 to close down*.'[384] Two more responses[385] indicated that cases where the appointment of a liquidator was necessary were of particular concern/difficulty.

The levels of agreement across different qualification groups varied significantly (Figure 72), with 'Other' accountants being the least likely to view dissolution formalities as an issue (48%[386] said that they were not). Whilst the 11-20 firm size group is an outlier, generally, an increase in firm size resulted in increased levels of agreement with the proposition that dissolution formalities are problematic (Figure 73).

383 This comment is extracted from the part of the survey which explores barriers to disincorporation (specifically) rather than dissolution (generally) but they equally apply here.

384 Another added '*there is a cost but it is small*.'

385 Comment in relation to disincorporation.

386 12/25.

Figure 72: Agreement that formality requirements for dissolution are a disadvantage of the company, by reference to qualification

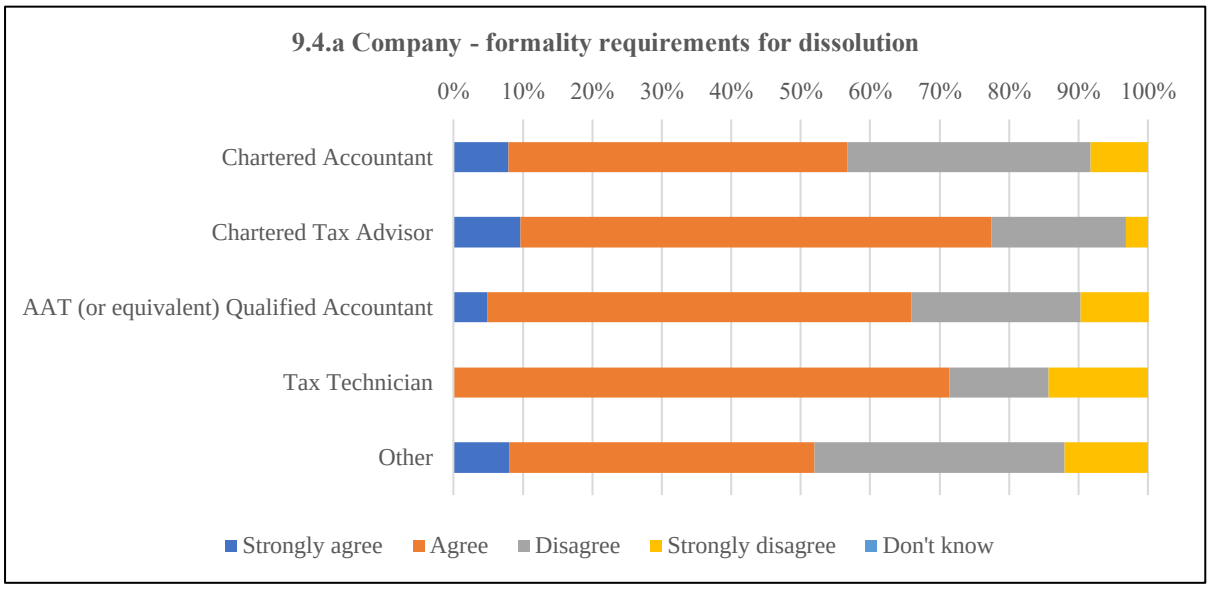
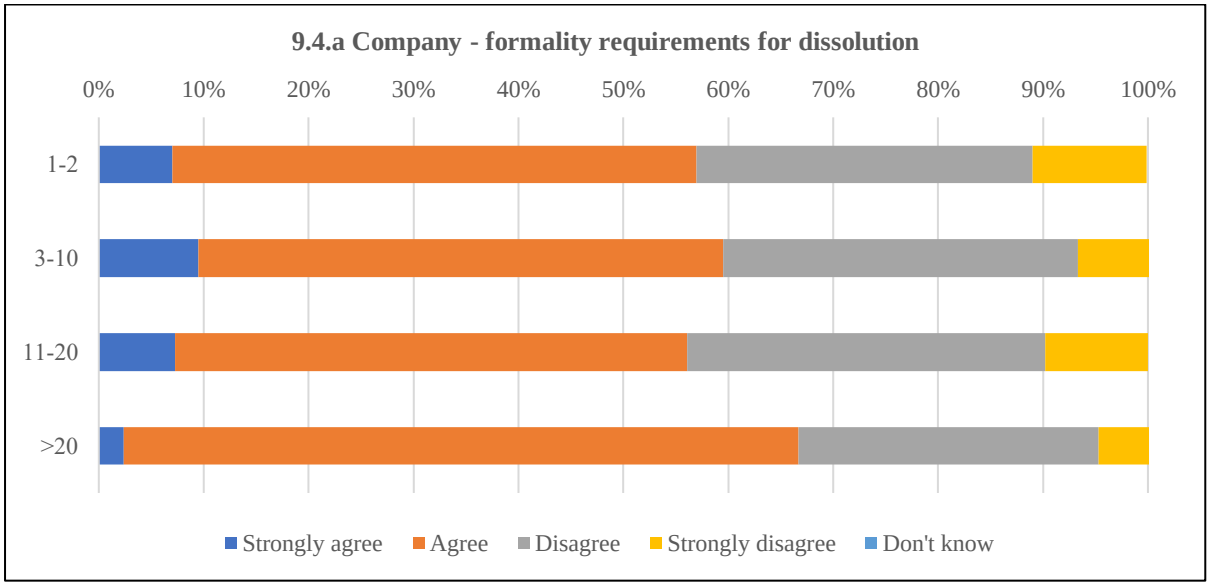


Figure 73: Agreement that formality requirements for dissolution are a disadvantage of the company, by reference to firm size



The survey also explored the barriers to *disincorporation* in more detail. 69.2%[387] of the respondents confirmed that they had assisted an owner-manager business with disincorporation, though four free text responses suggested that this was a rare occurrence and/or not worthwhile.[388] They were further asked to indicate whether they agreed that the following were barriers to disincorporation:

- Administrative costs;
- Need to amend/settle agreements with third parties;
- Tax payable by the company;
- Tax payable by the shareholders.

The two tax factors are discussed in detail in Chapter 5. One respondent suggested that getting shareholder agreement to disincorporate might be an additional barrier to disincorporation. An alternative to company dissolution is to have one of the owner-managers leave the business, with the business thereby continuing in the hands of those who remain. This is explored further in Chapter 3, alongside consideration of partner movement in and out of LLPs.

2.3.5.1 Administrative Costs

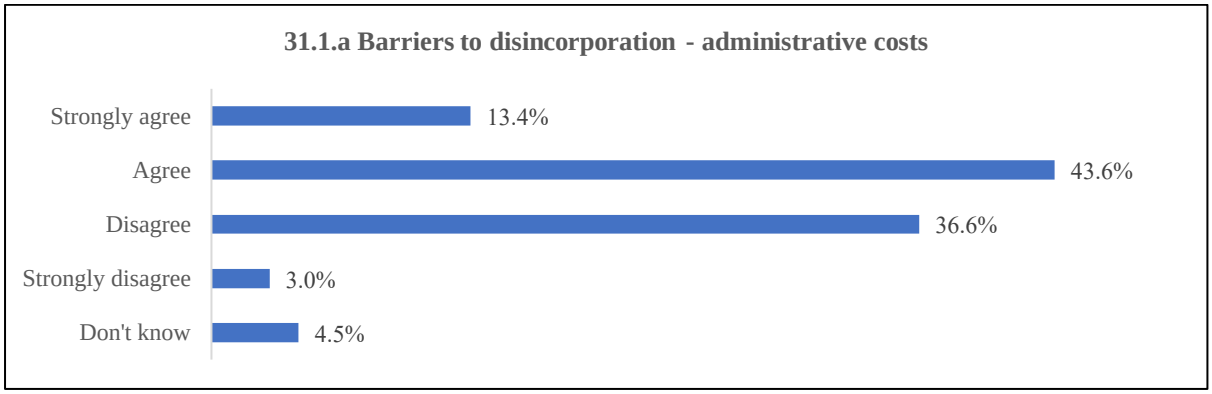
The source(s) of the administrative costs have already been noted. As expected, the views expressed in response to this question in the context of disincorporation cohere with the

387 222/353.

388 '*Nobody ever disincorporates in practice in my experience'*; '*very rare occurrence just strike off company*'; '*you wouldn't do it. A company is the default option, you would have to have a very good reason to change back to a partnership/sole trader'*; *'no seroius [sic] benefits*.'

responses in relation to the proposition that the formality requirements for dissolution are a disadvantage of the company form. 56%[389] agreed that the costs are a barrier to disincorporation.[390] Two respondents[391] added that the time taken to effect disincorporation is an issue; for an informal (simple) winding up will take at least six months.

Figure 74: Agreement that administrative costs are a barrier to disincorporation[392]



The most experienced respondents (more than 10 years advising) were significantly more likely than the other experience-based groups to agree that the administrative costs associated with disincorporation operated as a barrier (+12.2% more than the 6-10 years category). The overall tendency to agree increased with length of time advising (Figure 75). In addition, levels of agreement with the proposition that administrative costs operate as a barrier to disincorporation also increased in line with firm size i.e. the larger the firm, the greater proportion of respondents agreed (Figure 76).

389 188/336.

390 A cross tabulation was run to see if the views of those who had/had not assisted with disincorporation were substantially different. They were not.

391 There were 19 free text responses to this question.

392 Cross-tabulated data for qualification has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Figure 75: Agreement that administrative costs are a barrier to disincorporation, by reference to experience

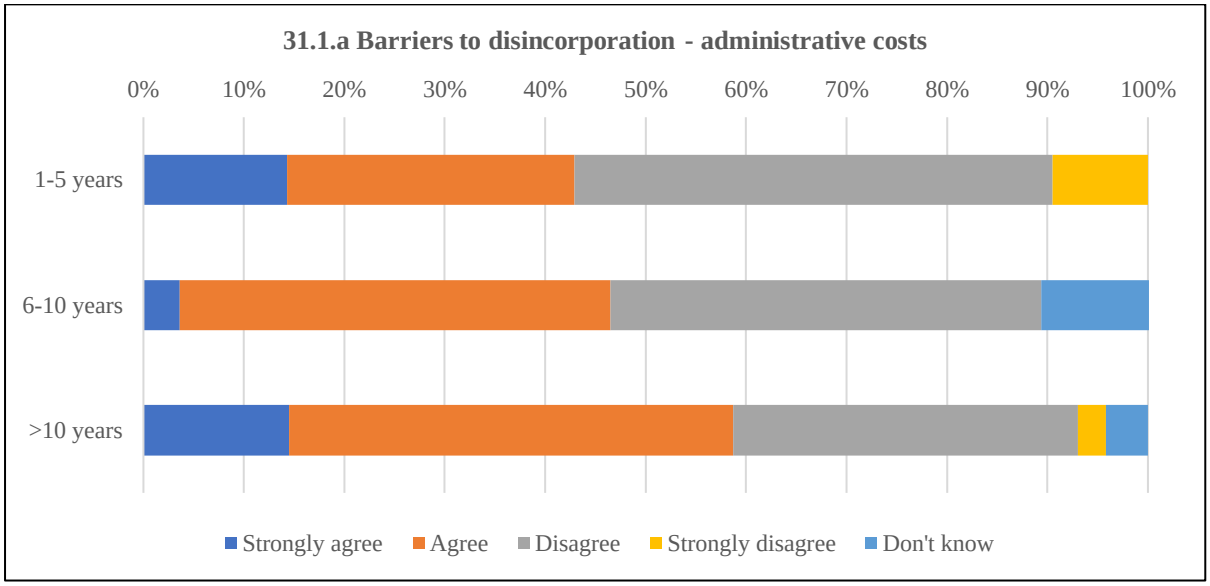
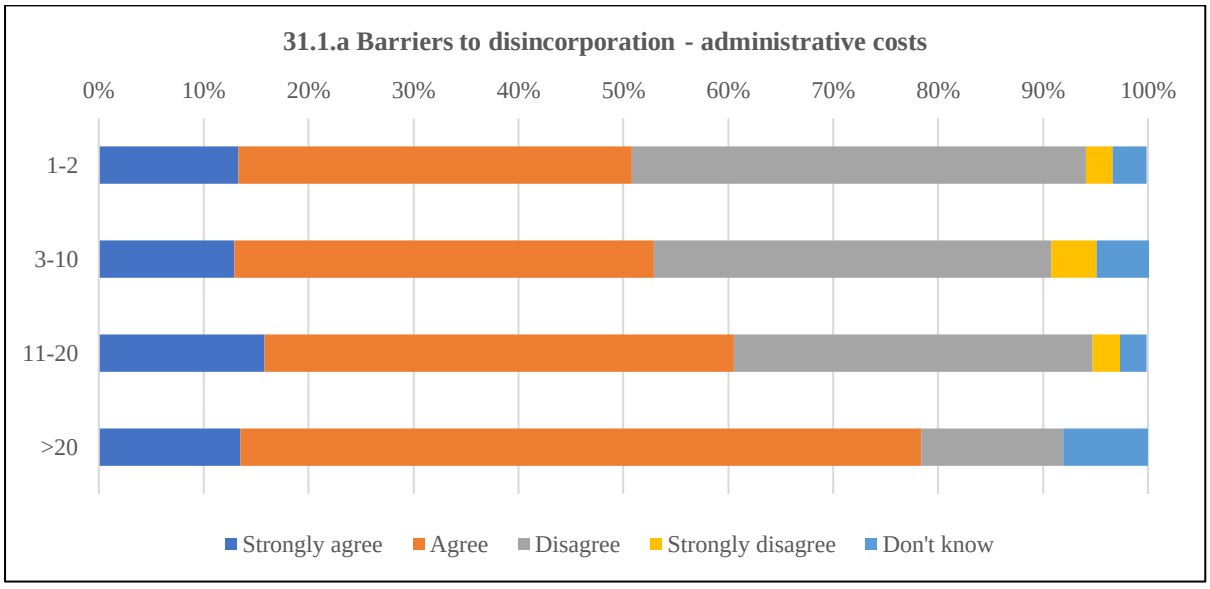


Figure 76: Agreement that administrative costs are a barrier to disincorporation, by reference to firm size



2.3.5.2 Need to Settle/Amend Agreements with Third Parties

In the event that the owner-manager disincorporates and thereby continues to trade through an unincorporated form, after having transferred the assets of the businesses they will also 'need to inform customers and suppliers of a change in business status, set up a new bank account, make other administrative changes (such as amending the business letterhead), and may have to change the funding arrangements for the business.'[393] This is simply the consequence of the company having had separate legal personality; the company assets and liabilities cannot be attributed to the owners, even where they directly manage the business.

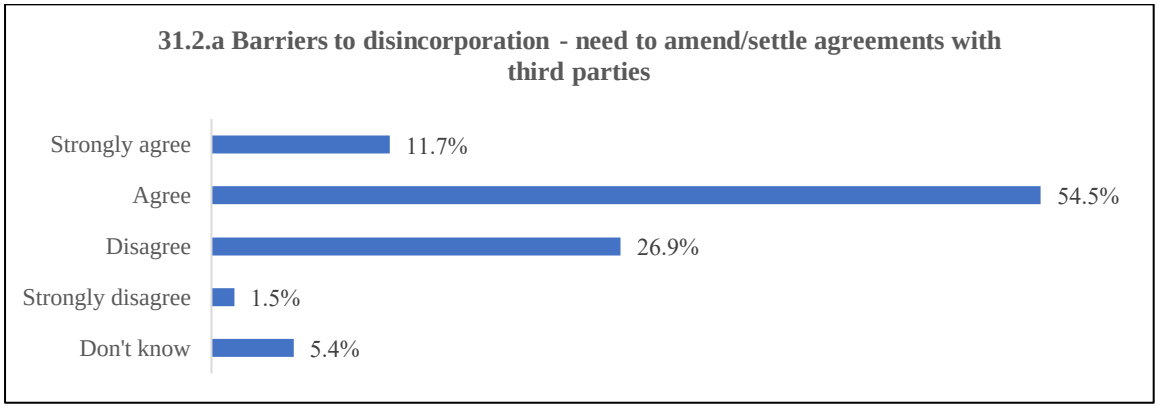
66.2%[394] of the surveyed accountants concurred with the proposition that the need to settle/amend agreements with third parties was a barrier to disincorporation (over 10% more than agreed that administrative costs were a barrier).[395]

393 McLaughlin and Anderson (n 124) 395.

394 221/334.

395 One commented: '*complicated to box everything up with all suppliers etc and contracts admin*.'

Figure 77: Agreement that the need to amend/settle agreements with third parties are a barrier to disincorporation[396]



Cross-tabulation of the data on the basis of qualification once more reveals different viewpoints across the category, but without a clear overall trend (Figure 78). Using firm size as a data reference point demonstrates that accountants based in the largest firms (more than 20 accountants) were significantly more likely to see third party matters as a barrier to disincorporation than those in smaller firms (across these groups the figures are broadly consistent) (Figure 79).

396 Cross-tabulated data for experience has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Figure 78: Agreement that the need to amend/settle agreements with third parties are a barrier to disincorporation, by reference to qualification

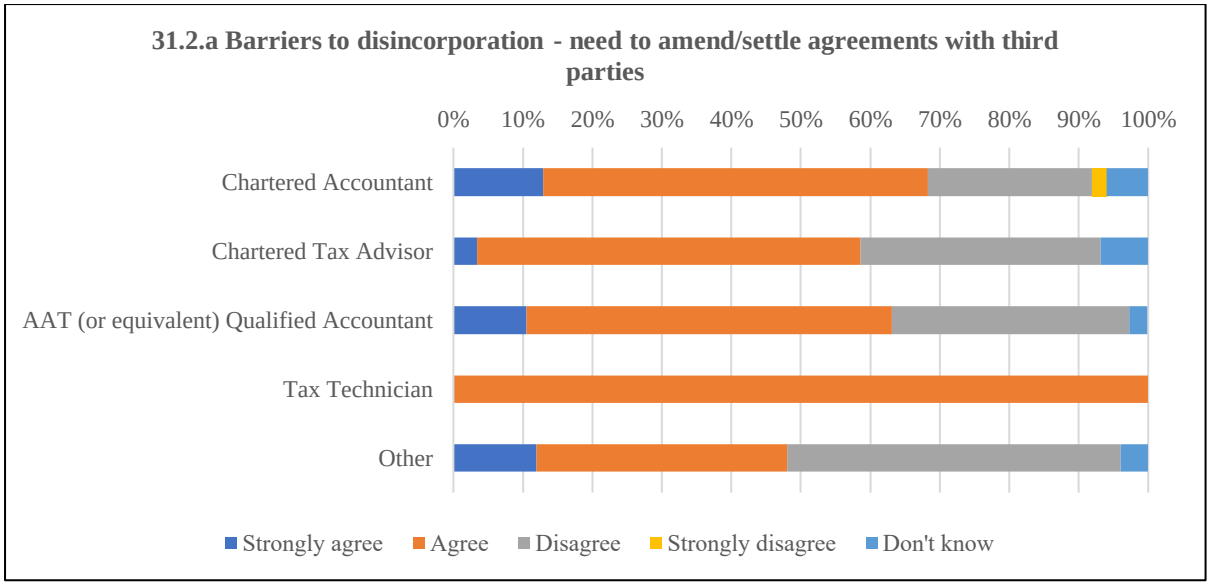
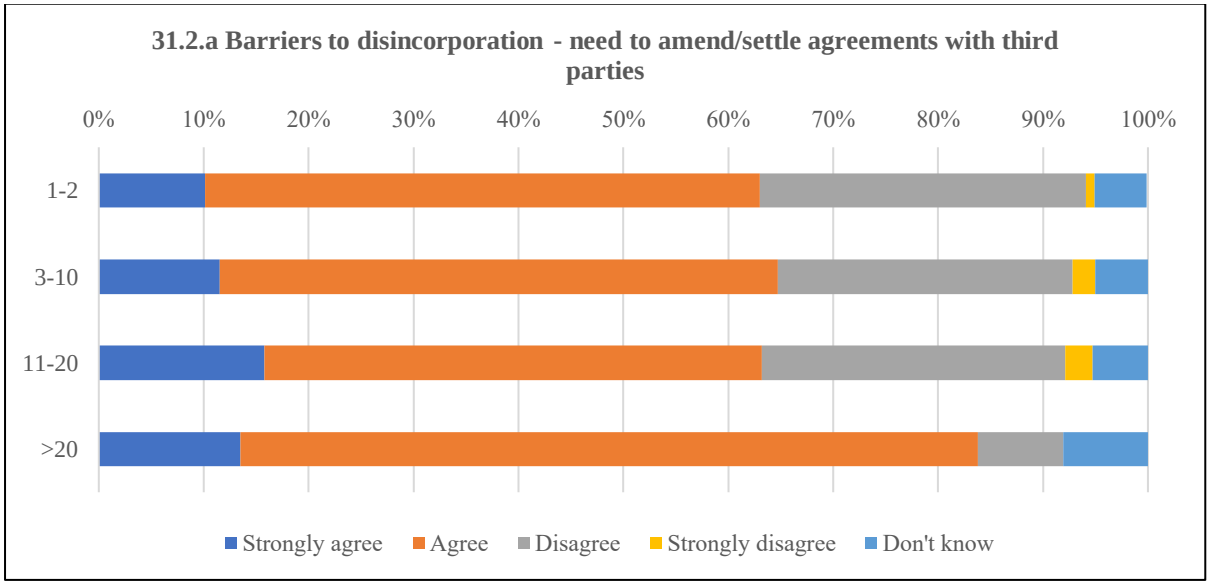


Figure 79: Agreement that the need to amend/settle agreements with third parties are a barrier to disincorporation, by reference to firm size



It is clear that in cases of both dissolution and disincorporation, the complex process involved in winding up a company (whatever the reason) is burdensome for owner-managers. The complexity of the process is compounded if one wishes to disincorporate and continue trading as an unincorporated form. One accountant fairly observed that '*well of course there can be barriers but they are not insurmountable and have to be done anyway*.' This is true, but it would be most prudent for the matter to be considered *before* incorporation, as part of the decision to (or not incorporate) though it seems perhaps unlikely that it is.[397]

2.3.5.3 Partnerships

Owing to the fact that partnerships are not regulated by company law requirements, nor registered with the Companies House, there is no need to engage with the Companies House should the partners wish to cease trading (though of course there will be such a need in the event that the partnership is incorporating). Since the partnership is a creature of contract, it is simply terminated by agreement, express or implied. The absence of the formal processes explained above thereby makes terminating a partnership much easier than the company.[398] That is not to say that there are no administrative arrangements to be made when a partnership comes to an end. The soon to be ex-partners will still need to agree upon the proper distribution of assets and if/how to settle any liabilities. The asset issue may become acute where property owned in the sole name of one partner was used in the course of the business. Section 20(1) PA 1890 deems that the property 'originally brought into the partnership, or stock acquired…'

397 Crawford and Freedman (n 5) 1043: 'There may be costs of incorporation which may sometimes be hidden – arising only, for example, on the break-up of a business relationship, where it may be more difficult for a shareholder to extricate himself from a company than it would have been for a partner to end a commercial partnership.'

398 Sometimes too easily, since the partnership will automatically be terminated upon the death of a partner.

must be regarded as a partnership asset (unless it can be shown that there was a lease), meaning that upon dissolution it should not be assumed that it will automatically revert to being owned by the partner who introduced the asset. Notwithstanding this point, the process is still relatively easier than that involved in the dissolution of the company. The fact remains that, whilst it would not be sensible to do so, one could simply walk away from a partnership and need do nothing more (personal liability for any prior engagements would continue in this event).

If, however, the partnership is being terminated because of a decision to incorporate, then of course the costs and formalities previously described, will bite. In addition, the assets of the partnership must be appropriately dealt with:

> [i]f the company is to carry on in succession to the individuals, the assets must be transferred to it. This transfer could be effected by way of gift, though a sale, whether for full value or otherwise, is more likely. The proceeds of sale may be shares, loan stock, unsecured loans or even cash. The whole arrangement is a formal transaction and there ought to be evidence that it has taken place...
>
> No doubt many small businesses have incorporated without documentation and now trade satisfactorily as companies. However, in most instances some form of documentation is to be advised…Not having a document of transfer is likely to prove a false economy in some instances.[399]

Such documents will also assist in the demonstration of title to the assets in the event that company assets, or even the company, is subsequently sold. Formal documentation, complying with the requirements of section 162 Taxation of Chargeable Gains Act 1992 (**"TCGA 1992"**) will also be necessary to avoid the potential adverse effects of incorporation

[399] McLaughlin and Anderson (n 124) 235, 237 and 238: '[o]n the face of it the document need not be excessively complex as it records a sale and purchase of assets and a business between related parties. It needs to state: details of the parties; details of assets transferring – stock, goodwill, plant and equipment, contracts, licences, cash, debtors, etc; a statement that the business is being sold as a going concern (for VAT). Also to bear in mind are premises (freehold or leasehold), employees, bank accounts, etc.'

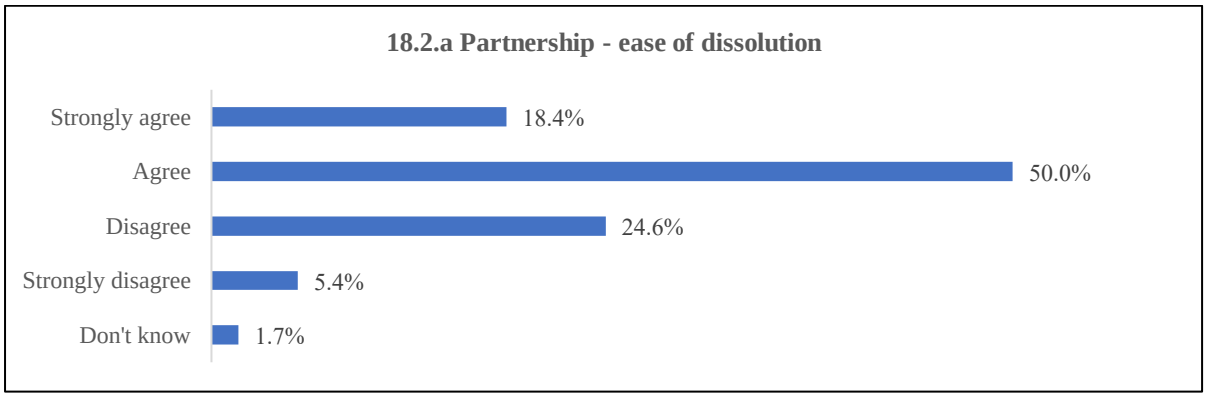
– this is discussed in more detail in Chapter 5. In relation to previous agreements with third parties, in so far as debts and obligations are concerned, the former partners could simply continue to be personally liable, and therefore not need to make alternative arrangements, though it may be prudent to do so. Other matters, such as supplier agreements, are likely to need addressing upon transfer of the business. To suggest, therefore, that incorporating an existing business is free from difficultly would be misleading, but it does appear comparatively easier than it is to disincorporate and existing company.

The respondents to the author's survey confirmed the view that dissolving a partnership was easier to do so than a company. A total of 68.4%[400] agreed that ease of dissolution was a partnership advantage, with the high numbers of accountants in the 'strongly agree' group being particularly noteworthy when compared to the figures from other questions. Only 40.8%[401] believed that the company was easy to dissolve.

400 242/354.

401 147/360. Based on the number of accountants who disagreed that the formality requirements for dissolution were a disadvantage of the company form. The author appreciates that there may be some bias involved here as the matter was presented as a disadvantage rather than an advantage.

Figure 80: Agreement that ease of dissolution is an advantage of the partnership[402]

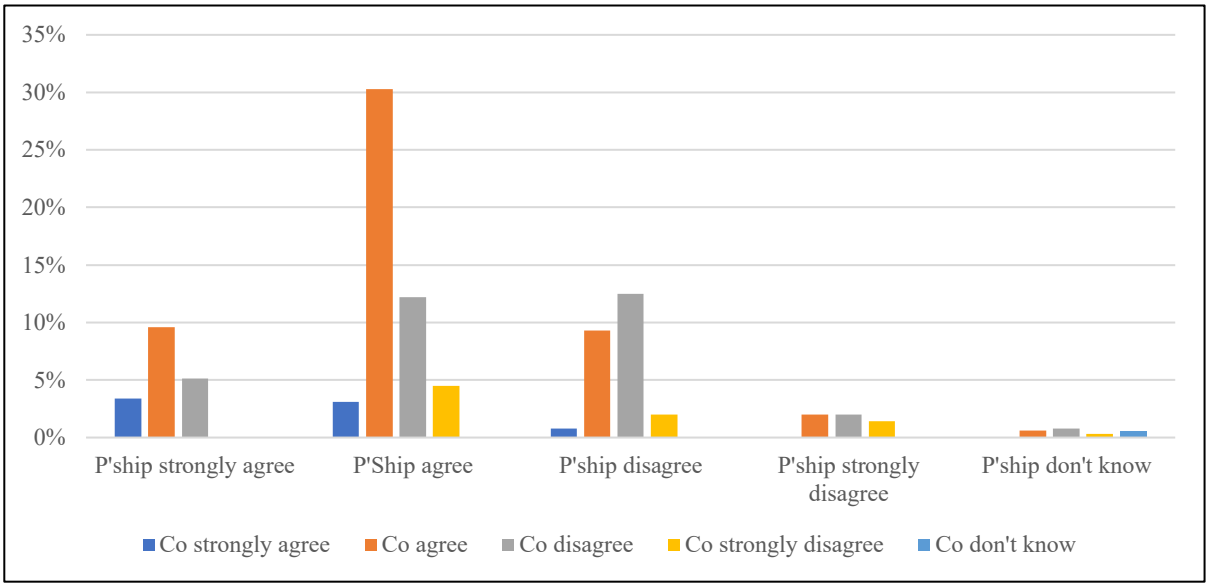


46.4%[403] also provided consistent responses, simultaneously agreeing that the formality requirements associated with the dissolution of a company were a disadvantage of the form, and that the ability to easily dissolve a partnership was a significant advantage.

402 Cross-tabulated data for qualification, experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

403 164/353.

Figure 81: Agreement that formality requirements for dissolution of a company are a disadvantage and ease of dissolution is an advantage of the partnership



At the start of this section, it was suggested that the company form should be regarded as less attractive if, having commenced business as a company, the legal and regulatory requirements for dissolution (and disincorporation in particular) mean that the owner-manager is effectively 'locked in' to the form i.e. would encounter difficulty and possibly considerable expense if they chose to dissolve the company. Unfortunately, the evidence indicates that this indeed is the case, even before tax matters are taken into account. Given the relative ease of both terminating and incorporating a pre-existing partnership, it appears odd that owner-managed businesses do not seem to be *starting* business in partnership, and then *subsequently* choosing to incorporate if appropriate to do so.

2.3.6 Understanding the Company Form

One key difference between partnerships and companies is that in respect of the latter, upon incorporation, the business 'owner' will likely become a shareholder, director and an

employee, and thereby technically cease to be the owner of the underlying business.[404] The CA 2006 governs the relationship between the shareholders, directors and creditors and is premised on the assumption that there is a separation of ownership and control, along with a need to monitor the management of the company.[405] That assumption might be regarded as inappropriate where there is no actual separation of ownership and control, as is the case with an owner-managed company, but such is the legislative scheme that attaches to the company form.[406] As a result, there is an underlying need for owner-managers to familiarise themselves with the duties and administrative burdens associated with operating as a company and take responsibility for ensuring compliance. Unfortunately, anecdotal and empirical evidence suggests that owner-managers are not always successful in doing so.[407] 'The parties running the business are often inclined to treat their companies as indistinguishable from themselves.'[408] The OTS Small Company Taxation Review observed that '[m]any proprietors simple do not understand the accounting and tax requirements of a company but are comfortable with the requirements of an unincorporated business.'[409] Crucially, it appears that

404 Crawford and Freedman (n 5) 1030. Though as a shareholder (if applicable) they would be regarded as having an ownership interest in the *company* but that is distinct from the underlying company assets which would be the subject matter of ownership in the unincorporated form.

405 Crawford and Freedman (n 5) 1043.

406 Crawford and Freedman (n 5) 1043.

407 OTS Disincorporation Relief Report (n 200) 14: 'In terms of administrative difficulties for companies, the agents' survey also showed that a significant proportion of small companies face charges due to overdrawn loan accounts, when directors do not distinguish between personal and business spending…of those respondents that indicated that most businesses suffer such [overdrawn loan account] charges, 8% said that at least 50% of their clients would like to disincorporate (compared to 4% for the population as a whole).'

OTS Small Company Taxation Review (n 40) 8, 79: 'a not insignificant proportion of small companies were formed because owners did not understand the full implications of incorporation….[a] fundamental concept, which we have been advised is often misunderstood, is that a company is a separate legal entity from its shareholders.'

408 Gower (n 30) 137.

409 (n 40) 9.

there is a particular issue with regard to the separation of personal assets and company assets, though the OTS has also noted that owner-managers also have problems understanding that they are an employee of the company.[410] 14 respondents to the author's survey added the lack of understanding of legal separation as a problem associated with the company form for owner-managers. Comments included:

> *'... the owner simply doesn't understand that they are not able to just carry on as before and pay for all of their personal things through the business, normally there are no problems but some clients are impossible to retrain!'*

> *'Difficulties with owner managers making the distinction between and / or having access to the company's Assets / Bank Reserves.'*

> *'Clients often find it difficult to understand how they, as individuals, fit into a corporate structure.'*

Not only is the failure to separate company assets from personal assets in violation of company law requirements, the respondents to the author's survey also made specific references to the issue of directors' loan accounts. Poor financial discipline is likely to result in owner-managers drawing upon company funds as though they were their own. The consequence may be that the director (or other close family members) thereby technically takes a loan from the company, whether or not this is appreciated at the time of drawing. Where the loan is then left outstanding for more than 9 months after the company's accounting period ends – which is most likely where there is a lack of understanding on the part of the owner-manager - the company will be required to pay tax, currently at a rate of 32.5%, on the outstanding loan balance under section 455 Corporation Tax Act 2010 ("**CTA 2010**").[411] There

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410 (n 40) 9.

411 The statutory provisions are contained in ITEPA 2003, Pt 3, Ch 7.

McLaughlin and Anderson (n 124) 323-4: 'tax is charged as if it were an amount of corporation tax, but it is not actually corporation tax and cannot be set against any other liabilities…where the loan is repaid

will be further charges to income tax on the owner-manager at a personal level if the loan is interest free and exceeds £10,000;[412] this will be on the basis that an employment-related loan is a benefit in kind,[413] and the company will also need to pay Class 1A NICs at the 13.8% rate on the full amount.[414] The owner-manager will incur a further income tax charge if the loan is subsequently written off, though any corporation tax paid by the company may be repaid in these circumstances.[415] The charges are no doubt a trap for the unwary, and the statutory provisions engaged by loan arrangements are notoriously complex. In this respect '[t]here must be numerous small companies whose businesses could be carried on more safely and efficiently through a sole trader or partnership…'.[416] The safety point is key. Whilst it would be ideal for all owner-managers to separate their personal and business assets, the law does not punish a failure to do so when one operates through an unincorporated form (or through an LLP). The

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to the company before the due date for payment of the tax (i.e. nine months and one day after the end of the accounting period), no s455 payment is actually required.'

There are also 'bed and breakfasting' provisions which prevent the loan being paid off shortly before the end of the nine-month period and then a similar amount being borrowed shortly after. The provisions are complex – see CTA 2010, Pt 10, Ch 3B.

The charge actually applies to a 'participator' as defined in CTA 2010, s 454(2). A participator is generally a director and/or shareholder, but is broad and includes: any person who possesses, or is entitled to acquire, share capital or voting rights in the company; any loan creditor of the company; any person who possesses, or is entitled to acquire, a right to receive or participate in the distributions of the company or any amounts payable by the company (in cash or in kind) to loan creditors by way of premium on redemption; and any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for their benefit.

412 If a loan above £10,000 is made without the members' consent under CA 2006, s 197 there will also be a breach of company law requirements, though only civil consequences ensue from such a breach.

413 ITEPA 2003, Pt 3, Ch 7.

414 For information on the application of National Insurance to benefits in kind see HM Revenue & Customs Guidance 2020: *Class 1A National Insurance Contributions on Benefits in Kind, Termination Payments and Sporting Testimonial Payments*, 2020 <https://www.gov.uk/government/publications/cwg5-class-1a-national-insurance-contributions-on-benefits-in-kind/2020-class-1a-national-insurance-contributions-on-benefits-in-kind--4> accessed 3 April 2022.

415 CTA 2010, s 458(2); ITEPA 2003, s 188 (taxed as earnings from employment); ITTOIA 2005, s 415 (taxed on the participator basis). In the event of conflict between the two income tax charges, ITTOIA 2005, s 415 prevails (ITEPA 2003, s189(1)(a)).

416 Rayney (n 68) 27.1.

drive to incorporation seems even more surprising when one considers the point that a significant proportion of owner-managers simply do not understand how the company form works on this day-to-day level; it appears that the misconceptions in relation to companies are not confined to limited liability and prestige but are more widespread. The fact that anecdotal accounts of these difficulties have not permeated and deterred the owner-managed business community from incorporating is curious.

2.4 PARTNERSHIP USAGE

Notwithstanding the decline in the number of partnerships generally, the majority of the respondent accountants (74.2%)[417] had previously advised an owner-managed business to form a partnership (Figure 82), most of which fell within the Chartered Accountant and Chartered Tax Advisor qualification groups (Figure 83). Indicative of the overall decline in the popularity of partnerships in recent years is that fact that those that had been in practice for the least amount of time were also least likely to have advised such a business to form a partnership – ranging from 50%[418] in the 0-5 years bracket to 77.4%[419] in the more than 10 years' experience category (Figure 84).

417 262/353.

418 12/24.

419 229/296.

Figure 82: Percentage of accountants that have advised an owner-managed business to form a partnership

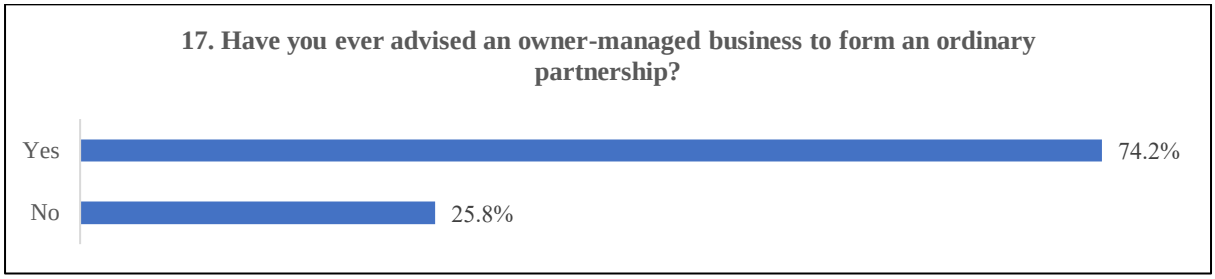


Figure 83: Percentage of accountants that have advised an owner-managed business to form a partnership, by reference to qualification

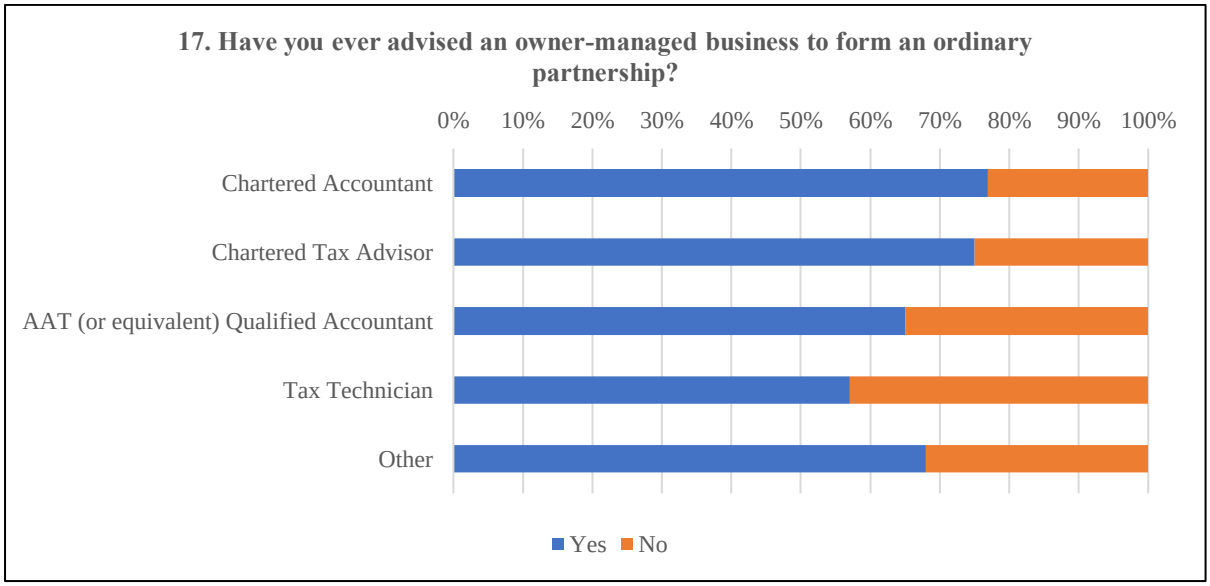
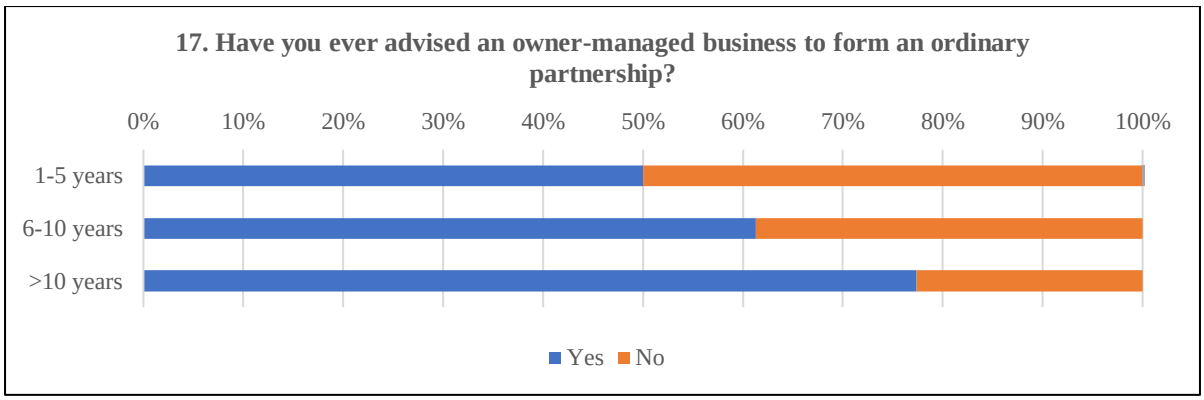


Figure 84: Percentage of accountants that have advised an owner-managed business to form a partnership, by reference to experience

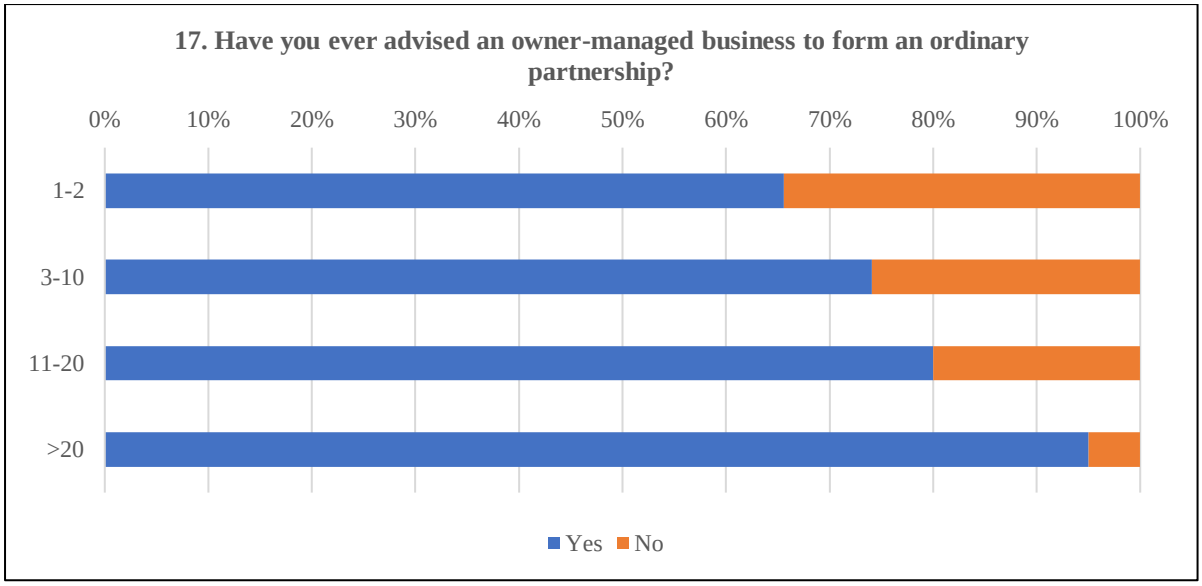


Another trend detected was that larger firms (95% in firms with more than 20 accountants)[420] were much more likely than smaller firms (down to 65.6% in firms with 1-2 accountants)[421] to have advised an owner-managed business to form a partnership (Figure 85), perhaps again reflecting a broader range of expertise in larger firms.

420 38/40.

421 82/125.

Figure 85: Percentage of accountants that have advised an owner-managed business to form a partnership, by reference to firm size



The respondents were most likely to have advised owner-managed businesses in the professional, financial and technical sector (58.3%),[422] and those in agriculture (35.6%)[423] to form partnerships. Partnerships have traditionally been used in these industries and represent a familiar way of working, so this result was to be expected. The high percentage detected in the agricultural sector also makes sense given that 33%[424] of the respondents did not think that limited liability was important for farming businesses. However, outside of the agricultural category, there was no correlation between the views upon the importance of limited liability

422 As previously noted, the professional and technical activities comprise a high proportion of the SME business population as a whole, so accountants are significantly more likely to have advised this sector in relation to form generally.

423 McLaughlin and Anderson caution against incorporation in the agricultural sector (n 124) 86: 'Particular trades have particular rules and it seems that the farming fraternity can come off badly when incorporating. Indeed, whilst many farming companies are long-established and provide a satisfactory trading medium, it is questionable whether incorporation will often be suitable in the sector. Generally speaking, incorporation should never be taken lightly – and this is especially the case with farmers.'

424 19/58.

and the likelihood of having previously advised an owner-managed business to form a partnership (Figure 5 above). This again calls into question the significance of limited liability considerations when advising owner-managed businesses in relation to form.

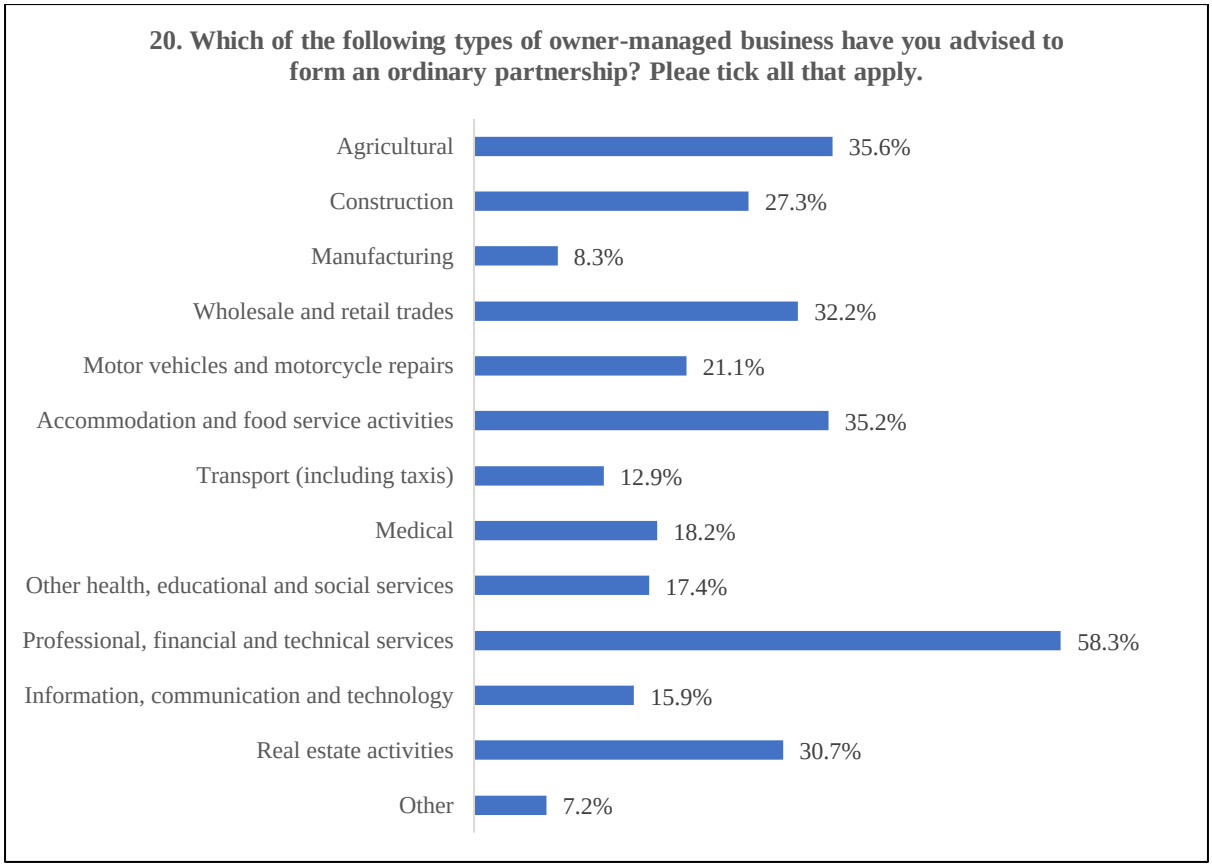
The low percentage (18.2%) in the medical category is somewhat surprising given the historic use of partnerships by medical professionals:[425]

> [t]he partnership model has been the main legal structure for GP practices delivering primary medical care for over 100 years – the Royal College of General Practitioners holds records of attempts to establish a representative body for general practice as early as 1844. It is the flexibility and adaptability of the model that mean it can still thrive today.[426]

[425] This is due to some restrictions on the legal form that can bid for certain NHS contracts. For further information see: Daphne Robertson, *Incorporating your NHS Practice* <https://www.firstpracticemanagement.co.uk/media/1052/incorporating-an-nhs-practice.pdf> accessed 3 April 2022.

[426] *GP Partnership Review: Final Report* (n 88) 20. The Report discusses the operation of the partnership model in practice for GPs and reaches an overall positive conclusion at 21: 'the partnership model has many strengths that continue to be relevant in the health service of today and the future. The review has seen many examples of partnerships thriving in local areas, and the accompanying case studies document showcases some examples of how practices have used the flexibility of the partnership model to overcome challenges.'

Figure 86: Percentage of accountants that have advised an owner-managed business to form a partnership, by industrial sector



What can be seen is that although the sectoral distribution in partnership usage differs to that of the company, there is a comprehensive spread of partnerships across all types of industry indicating a possible universal appeal of partnerships for the owner-managed business community. Accordingly, they should be regarded as potentially suitable for any type of owner-managed business.

2.5 CONCLUSION

Overall, the findings of the author's survey and other empirical research in this area do not support the view that the decline in the popularity of the ordinary partnership can be conclusively attributed to commercial (non-tax) reasons. Even today, *Gower's Modern Principles of Company* law maintains the standpoint that 'in small businesses the company as a business vehicle faces a distinct challenge from…the partnership.'[427]

The author's findings confirm the status quo that limited liability associated with the company form is the primary draw. Yet it is concerning that the accountants surveyed also confirmed the prevalent use of the personal guarantee to undermine limited liability, without appreciating that this should impact upon the advisory process in a significant way. This points to embedded cultural use of the corporate form (which may have been stimulated by the tax matters to be considered in Chapter 4). Figure 87 presents a comparative summary of the advantages associated with the company and partnership forms respectively, and clearly highlights the benefits of the partnership as including a flexible business structure, low administrative and compliance burdens, ease of set up, a high degree of personal control and easy dissolution.

427 Gower (n 30) 13.

Figure 87: Comparative summary of company and partnership advantages, by levels of agreement

	COMPANY	PARTNERSHIP
Limited Liability		
Separate Legal Personality		
Formal Business Structure		N/A
Flexible Business Structure		
Ability to Sell/Transfer Shares		N/A
Prestige/Credibility		
Ability to Satisfy Customer Requirements		N/A
Financing Options		N/A
Low Administrative/Compliance Burdens		
Ease of Set Up		
(Potential) Cost of Set Up		
Privacy		
Degree of Personal Control	N/A	
Ease of Dissolution		
Agree (More than 65%)		
Agree (50-64%)		
Disagree (Less than 50%)		

Whilst the partnership form is not perfect – the issue of drafting a comprehensive agreement apparently being the biggest barrier[428] – and will not be suitable for all types of owner-managed business e.g. those with special customer requirements and the need to access more flexible loan agreements, for many it offers a simpler mode of operating and ought to be regarded as attractive, especially for owner-managed businesses. This is especially the case for owner-managed businesses that would have limited liability undermined by the personal guarantee, struggle to understand the corporate form (as independently highlighted by the respondents to the author's survey), value privacy, and/or suffer at the hand of increased administrative and compliance burdens. The partnership's advantages have not been denied by the survey results, yet the partnership continues to be the unpopular business form. The following two Chapters consider other possible reasons for this. Firstly, Chapter 3 explores

[428] It is possible that future research with legally qualified individuals would indicate a reduced cost burden for the drafting of a partnership agreement.

whether the pursuit of limited liability has led to ordinary partnerships becoming LLPs. Secondly, Chapter 4 considers the influence of tax considerations on the choice of business form, which is the key focus of this thesis.

CHAPTER 3: LIMITED LIABILITY PARTNERSHIPS

3.1 INTRODUCTION

For those wishing to gain the protection of limited liability, the LLP offers an alternative to the company form; it could be adopted from the inception of business, or arise from the conversion of a pre-existing business.[429] Upon the introduction of the LLP, Birds made the heavily contested[430] claim that it might be a 'genuine and much better suited form of business organisation for the small unincorporated partnership.'[431] Given that the DBEIS Business Population Estimates include LLPs under the 'companies' umbrella, it is plausible that some owner-managed LLPs are hidden by the published data. Accordingly, this Chapter explores whether the decline in the use of the ordinary partnership might, at least partially, be accounted for by an increased uptake of the LLP by owner-managed businesses. Notwithstanding some positive data published by Fletcher, Frecknall-Hughes and Williams,[432] which suggests that the LLP may be a suitable vehicle for the 'small and medium-sized business' sector as a whole, the author's research suggests that the LLP has not found favour with owner-managed businesses; it also evidences professional scepticism as to the benefits of the LLP for owner-managed businesses. The findings are presented below, alongside the data contained in the Fletcher, Frecknall-Hughes and Williams Report (**"LLP Report**").[433]

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429 Andrew Constable, 'Partnership Planning' in Rebecca Forster, *Tolley's Tax Planning 2021-22* (Lexis Nexis 2021) 45.1.

430 See, for example: Freedman (n 98); Finch and Freedman (n 354).

431 Birds (n 256). See also Mark Sharpley, 'LLPs: Dispelling the Myths', New Law Journal (2009) 1108: '[t]here are very few reasons, other than public accountability that would detract a partnership from moving towards LLP status.'

432 (n 36).

433 (n 36).

3.2 THE INTRODUCTION AND OPERATION OF THE LLP

The Limited Liability Partnership Act 2000 ("**LLP Act**") was introduced as a result of substantial and sustained pressure, primarily from large accounting practices seeking to limit the personal liability of partners whilst also continuing to be treated on a look-through basis for taxation purposes.[434] The 'Big Five' accountancy firms became concerned about the unlimited personal liability of each partner irrespective of their degree of personal fault; they argued that a failure to introduce limited liability would lead to a 'liability crisis' resulting in defensive auditing, the avoidance of high-risk clients, and a deterrence from entering into the profession.[435] These claims did not appear to be supported by any compelling evidence, which did not go unnoticed when the Limited Liability Partnerships Bill was debated in the House of Lords. Lord Phillips[436] challenged the matter, and questioned the fundamental basis for the LLP:

> [w]here is the evidence to show that any of them needs the protection of this Bill in order for them to do their work effectively, competitively and profitably? There is no evidence. When did we ever hear of one of the big City solicitors losing his trousers? I have never heard of it…

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434 E Rowlands and I Zeider, 'Limited Partnerships and Limited Liability Partnerships' in Rebecca Forster, *Tolley's Tax Planning 2021-22* (Lexis Nexis 2021), 36.18. Fletcher, Frecknall-Hughes and Williams (n 36) 1: 'some criticism was levelled at the government as a result of the introduction of the [LLP] form…as it was perceived as allowing accounting firms (and also law firms) to create a business form which would enable them, through limited liability protection, to side-step their responsibilities for negligent activities and thus protect the personal assets of partners from liability arising out of professional negligence claims.' See Geoffrey Morse and others, *Palmer's Limited Liability Partnership Law* (3rd edn, Sweet and Maxwell 2017) A1-09 to A1-19 for an account of the legislative history.

435 Phillip Morris and Joanna Stevenson, 'The Jersey Limited Liability Partnership: A New Legal Vehicle for Professional Practice' [1997] MLR 538, 541. See also: Saleem Sheikh, 'Limited liability Partnerships: A New Trading Vehicle?' (1997) ICCLR 270; Jennifer Payne, 'Limiting the Liability of Professional Partnerships: In Search of this Holy Grail' (1997) Company Lawyer 81.

436 Hansard, Volume 607: 9 December 1999, 1433. He also proceeded to question the morality of the proposal: 'I have to say that to extend the unique public privilege of limited personal liability primarily for the benefit of the largest, most lucrative and successful partnerships, which, in turn, act for the largest and most lucrative companies, strikes me as perverse, verging on the bizarre. Of course it will also protect smaller firms, but my impression and experience is that that is not a major issue for them.'

> I believe that the Bill is wholly unnecessary. All firms take out insurance. Those who find that inadequate are at liberty—and many of them exercise that liberty—to agree an upper limit on liability with the clients for whom they do the work.

Similar observations were made by Mr Austin Mitchell (Member of Parliament) during a later debate:[437]

> I am sure that the hon. Gentleman will go on to paint the tear-jerking spectacle of those in accountancy partnerships living in terror in case their yachts, farms, pubs and holiday retreats are suddenly confiscated, but has it ever happened? We estimate that the total revenue set aside from the fee income for contingency claims was no higher than 2.7 per cent. Most of the things that are claimed to be a threat over accountancy never materialised.

However, one may argue that the simple threat of negligence actions alone can act as a dampener on work.[438] Notwithstanding the scepticism, it appears that governments in a number of jurisdictions felt under pressure to introduce a partnership form with limited liability.[439] Jersey was the first in the British Isles to respond and introduced its own form of limited liability partnership, with separate legal personality, in the Limited Liability Partnerships (Jersey) Law in 1997. The motivation to act quickly, from Jersey's perspective, was to protect its reputation as an important financial centre.[440] The opportunity to undercut any response by

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437 Hansard, Volume 350: 23 May 2000, 893.

438 Mr Nick Gibb (Member of Parliament), ibid.

439 Morris and Stevenson (n 435).

Mitchell (n 437) 898: 'The change in company and partnership law is being done at the behest of the mighty and the greedy, and indeed the mighty greedy. The lobby for the Bill comes overwhelmingly from the big five—formerly big six, until they started eating each other—accountancy houses. The fee revenue of the big five was £4.5 billion in this country alone in 1999. That makes them powerful organisations, and I do not like the spectacle of the Government rushing to serve their purposes, their greed and their desire to protect their profits, revenues and incomes as partners.

440 Morris and Stevenson (n 435) 543. Edward Quinn, 'Jersey: partnership – limited liability' (1996) Int ILR G118: 'Jersey first announced the proposal to introduce the law…just days after the news of a huge damages award in a negligence action against a major accountancy practice'. The case was: *ADT Limited*

the UK partially arose from the fact that the UK consultation process for the LLP took almost three years.[441] The Jersey legislation itself was drawn up by Slaughter & May and financed by the businesses previously known as Price Waterhouse and Ernst & Young, at the cost of £1 million. Even though it appears that some of the Jersey law draftsmen found the legislation unsatisfactory, it was 'nodded through', as allegedly promised to Price Waterhouse.[442] Morris and Stevenson described the law as:[443]

> a unique legislative experiment which, despite being legislation enacted by a small offshore jurisdiction, could well have a profound impact on the future legal framework of major United Kingdom professional practices, particularly those operating in accountancy and legal services sectors.

The introduction of a new form of business with the benefit of limited liability in and of itself was not unusual at that point in time. Writing in 2000, Freedman noted that '[n]ew limited liability forms of organisation are in vogue'.[444] By this point the LLP concept (and similarly the LLC) was firmly entrenched in the USA.[445]

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v BDO Binder Hamlyn [1996] BCC 808, though Morris and Stevenson (n 435) 542 note that the introduction of the Jersey LLP was being discussed even before this judgment.

441 David Milman, 'Limited Liability Partnerships: The Waiting Goes On' (2000) ICCLR 329. However, the actual Act itself, and the Regulations supplementing it, was drafted without consulting the Law Commission and is described by Mark Blackett-Ord and Sarah Haren, *Partnership Law* (5th edn, Bloomsbury Professional 2015) 675 as 'Third world legislation.'

442 Mitchell (n 437). The aforementioned described this as a 'devious manoeuvre'; '[t]hey were so anxious to secure limited liability that they went to the Jersey legislature and tried to buy legislation on their own terms'.

443 Morris and Stevenson (n 435).

444 See Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 MLR 317 for discussion of limited liability in other countries and, in particular, the USA. McCahery and others (n 354) 3.2: 'The introduction of new legal forms is beneficial because it avoids complex doctrinal and tax issues involved in law reform projects. The more widely used the form is, the more difficult it becomes to reform.'

445 See Larry Ribstein, 'Possible Futures for Unincorporated Firms' (1996) 14 University of Cincinnati Law Review 319; R Hamilton, 'Registered Limited Liability Partnerships: Present at Birth (Nearly)' (1995) 66 University of Colorado Law Review 1065.

As predicted by Morris and Stevenson,[446] the eventual response of the UK Government, in a bid to remain competitive,[447] was the introduction of the LLP Act 2000, which came into force on 6 April 2001. The move was made notwithstanding the fact that firms did not rush to use the Jersey LLP:

> [w]hen they got the legislation, they were warned by the Inland Revenue that there would be tax consequences if the set themselves up as limited liability partnerships in Jersey – so, after all that effort buying legislation in Jersey, no firm went there. They were using the process as a means of pressuring the Conservative Government.[448]

Since the introduction of the LLP Act 2000, any two or more persons may form an LLP with the dual characteristics of legal personality and limited liability.[449] Despite being designed at the demand of the professions the LLP is a model available to all.[450]

Naturally, the LLP was intended to be a partnership-company hybrid form; 'in many ways it is neither fish nor fowl. In some respects, it is closer to a partnership, while in others it is closer to a company.'[451] Yet, despite the fact that the LLP was designed with professional

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446 Morris and Stevenson (n 435) 538: 'it seems probable that Jersey's move will act as a catalyst for a similar rapid proliferation of LLP legislation in both small and large jurisdictions of the British Isles.' See also: Elspeth Berry, 'When is a Partner/LLP Member Not a Partner/LLP Member? The Interface with Employment and Worker Status' (2017) International Law Journal 309, 3.

447 Milman (n 441): 'this…option met with initial resistance from some quarters, but once it became apparent that professional firms would be prepared to go offshore (e.g. to jurisdictions such as Jersey…) to exploit this [LLP] medium a consensus developed that it would be preferable for English law to offer this option and to main its regulatory grip'.

Dr Kim Howells (Member of Parliament), Hansard, Volume 350, 23 May 2000, 889: 'The creation of LLPs demonstrates the Government's commitment to ensuring that Britain maintains its competitive and up-to-date legal framework for business.'

448 Mitchell (n 437) 901.

449 LLP Act 2000, s 1.

450 However, Freedman (n 444) has questioned whether limited liability is suitable for small firms, both in terms of economic efficiency and by reference to moral and political criteria.

451 Howells (n 447) 889.

partnerships in mind, the majority of law applicable to LLPs is a modified form of company law,[452] and not partnership law.[453] Section 1(5) LLP Act 2000 expressly provides that partnership law shall not apply to LLPs unless express provision is made to the contrary. The Limited Liability Partnerships Regulations 2001 operate to apply significant parts of the CA 1985, the CDA 1986 and the IA 1986 to LLP's.[454] The changes introduced by the CA 2006 resulted in further Regulations being passed.[455] The proposed extensive use of Regulations as

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452 There are currently four main sources of LLP law:

(a) The LLP Act 2000, as amended by The Limited Liability (Application of Companies Act 2006) Regulations 2009, SI 2009/1804;
(b) The Limited Liability Partnerships Regulations 2001, SI 2001/1090;
(c) The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008, SI 2008/1913 as amended in 2012 and 2015;
(d) The Limited Liability (Application of Companies Act 2006) Regulations 2009, SI 2009/1804.

Gower (n 30) 6: '[T]he LLP is usually governed by company law principles…the corollary is that partnership law principles do not generally apply to the LLP, except in two crucial respects. First, the members of the LLP are taxed as though they are partners. Secondly, the internal decision-making machinery for companies…is abandoned for the LLP.'

Palmer's (n 56): 1.208.2: 'Prior to the introduction of LLPs, there was a substantial debate as to whether an LLP was a corporate body or a merely a partnership with separate legal personality. The LLP Regulations embody a compromise between these two views. Admission to an LLP depends upon unanimity on the part of existing members and standard partnership rules governing the resolution of disputes and changes in the nature of the business apply. However, to give effect to the "corporate" view of an LLP, an unfair prejudice remedy within the LLP exists, although this remedy can be excluded by written and unanimous agreement between LLP members. One consequence of the fact that LLPs are regarded as new corporate bodies rather than partnerships with legal personality, is that reforms to corporate law frequently have to be translated into LLP terms.'

This matter was also discussed by Sales J in *F&C Alternative Investments (Holdings) Ltd v Barthelemy* [2011] EWHC 1731 (Ch) where he concluded that LLPs were more akin to companies than partnerships.

453 Morse (n 12) 320, comments that the LLP has been described as having no connection with partnerships and should be regarded as a breach of the Trade Descriptions Act 1968. However, the LLP does not have shareholders, share capital or directors even if it is customary for a member to be described as having a share in the LLP. That 'share' was described in *Reinhard v Ondra LLP* [2015] EWHC 26 (Ch) at [57] as being a 'bundle of financial rights and obligations arising from the internal LLP obligations.'

LLP Act 2000, s 15.

Ribstein (n 146) 128 has previously described the LLP as failing to integrate limited liability in a manner which is coherent with a partnership structure which operates on the basis of centralised management.

454 Morse (n 12) 316.

455 Morse (n 12) 316.

a source of LLP law came under scrutiny in the House of Lords. Mr Nick Gibb MP commented:[456]

> [f]ar too many key provisions are hidden in secondary legislation. From the now 19 clauses and one schedule, one would have no idea of some of the Bill's basic tenets. One would have no idea that a member of an LLP will remain liable to the full extension of his personal assets, notwithstanding the limited liability, for negligent work that he or staff reporting to him had carried out; no idea about a host of important issues relating to the legal position of members if the LLP trades while insolvent; no idea about which company law and which partnership rules will apply to the LLP. Those matters are in a host of regulations to be issued under sections 14, 15 and 16…
>
> The Committee's report draws attention to the fact that what is now clause 16 is "a Henry VIII provision which allows regulations to amend or repeal primary…legislation."

The effect of the statutory regime is that the LLP is subject to many of the controls imposed upon companies (e.g. preparation and disclosure of accounts, subject to DBEIS investigations, rules on names, addresses of members, auditors, registration and disclosure), which are typically regarded as the price for limited liability.[457] The obligations can be onerous, but are not quite as extensive as those imposed upon companies e.g. the LLP is not bound by regulations concerning the formal requirements for meetings, resolutions and maintenance of share capital.[458] Interestingly, the application of company law principles of any sort to ordinary partnerships was strongly opposed by the Law Commission.[459] This corporate approach to the

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456 (n 437) 895.

457 Morse (n 12) 320; Payne (n 435); Blackett-Ord and Haren (n 441) Ch 25.

458 See Palmer's (n 56) 7.401, 7.419, 7.502.

Notably, CTA 2010, s 455 does not apply to LLPs, meaning that a failure to keep personal and business assets separate will not generate director's loan account tax charges.

459 (n 164) 5.40.

LLP also makes the UK LLP markedly different from most LLPs established outside of the British Isles.[460]

Given the legislative history, and the corporate model of the LLP produced as a result thereof, it is beyond doubt that the LLP was not remotely geared towards small businesses.[461] In fact, before the work commenced on the development of the LLP, the Department of Trade and Industry had already concluded that there was no need for a new form of business vehicle for small firms that offered limited liability; the small company structure was deemed to suffice.[462] When the Law Commission conducted a review of partnership law the original terms of reference included 'whether the intended LLP structure might be made available to a wider range of business'. It was later concluded that the proposed LLP would not be adopted by small businesses and, accordingly, when the terms of reference were finalised the reference to the LLP disappeared - it was not explored any further.[463] However, the fact that small businesses were not involved in the process of developing the LLP structure,[464] and that the focus of the reform was the protection of professional partnerships from 'catastrophe' claims, does not necessarily entail that the structure is an inappropriate form for owner-managed businesses (including non-professional partnerships). Indeed, it is important to bear in mind that the

460 See, for examples in other jurisdictions: Lin Lin, 'The Limited Liability Partnership in China: A Long Way Ahead' (2010) ICCLR 259; Freedman (n 444); Mohammed Salim, 'Limited Liability Partnership in Malaysia: A Corporate Governance Perspective', (2013) ICCLR 421; H Yeo and J Lee, 'Limited Liability Partnership – New Business Entity in Singapore' (2006) Journal of Business Law 859.

461 Crawford and Freedman (n 5) 11.3.1. See also: Freedman (n 98); Finch and Freedman (n 354).

462 Freedman JCL (n 98) 898.

463 Finch and Freedman (n 354) 475, 477; Freedman (n 98); Law Commission (n 164) 1.8, 3.4.

464 McCahery and others (n 40) 2.1.1: 'Legislators, judges, practitioners, regulatory agencies, professional groups and legal scholars constitute an elite law-making group….the law and its evolution appear more like a battleground on which elites compete for hegemony rather than being a system of checks and balances.'

company was not designed for such businesses either,[465] but successive reforms have made its use more simple and attractive.[466] Reforms relaxing accounting and reporting requirements for small companies have similarly been extended to small LLPs.[467] Based on this information alone, it would appear perfectly feasible that LLPs are being used by a significant number of owner-managed businesses. As previously discussed, this could theoretically assist in accounting for the decline in the number of ordinary partnerships. However, this is not the complete picture. The following sections assist in filling in the gaps.

3.3 STATISTICS

Notwithstanding some initial debate as to the likelihood of the LLP being a success at all,[468] a number of large legal and accountancy firms have adopted the LLP form.[469] Those embracing the LLP include PwC, Deloitte, KPMG, Herbert Smith Freehills, Allen & Overy, Clifford Chance, Freshfields and Linklaters.[470] Given that such firms were the main protagonists of the

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465 See Harford (n 43).

466 See Birds (n 256); OTS Small Business Taxation Interim Report (n 273); Company Law Review Steering Group, *Modern Company Law for Competitive Economy: Final Report Volume I and II*, March 2000.

467 See Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912); Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016 (SI 2016/575).

468 Finch and Freedman (n 354); Geoffrey Morse 'Limited Liability Partnerships and Partnership Reform in the UK' in Joseph McCahery, Theo Raaijmakers and Erik Vermeulen (eds), *The Governance of Close Corporations and Partnerships* (OUP 2004); Stuart Cross, 'Limited Liability Partnerships Act 2000: Problems Ahead?' (2003) Journal of Business Law 268.

Payne (n 435) 81: 'An LLP with information disclosure, creditor protection, legal personality and yet the tax status of a partnership sounds like a strange beast but is potentially workable.' See, on limited liability partnerships generally: John Whittaker and John Machell QC, *The Law of Limited Liability Partnerships* (4th edn, Bloomsbury Professional 2016).

469 However, the growth did not occur with great immediacy. Prior to the implementation of the LLP Act 2000 Payne (n 435) predicted that 15% of all professional partnerships would become LLPs in 2001 but by 2002/3 there were only 4,500 active LLPs.

470 All checked by a Companies House search which can be accessed via the following link: <https://www.gov.uk/get-information-about-a-company> accessed 1 April 2022.

form this is unsurprising. In terms of the available figures, in the years 2015-16 the effective number of LLPs on the Companies House register hit its peak at 56,622[471] up from a meagre 5,542 in 2004 (+921.7%).[472] The numbers were fairly stable across the 2013-17 period as a whole, with the number of LLPs only fluctuating by approximately 1,000 in this time frame.[473] In the years 2012-14 LLPs comprised 1.8% of all businesses registered with the Companies House.[474] Nonetheless, there has been a gradual decline in the effective number of LLPs since the peak (-13.5%), with the 2019-20 Companies House release reporting that 49,510 were in existence (-2.3% on the previous year). They now account for just 1.1% of the Companies House Register (-0.7%), and therefore less than 1% of the business population as a whole.[475] This makes it unlikely that the introduction of the LLP form has caused a significant reduction in the number of ordinary partnerships, but there may nonetheless still have been some affect which can be explored. That task is made more difficult given that the publicly available figures do not disclose the average number of LLP members (this data is available for company directors and shareholders, as detailed at Part 1.1). The author made a freedom of information request to HMRC to ascertain the average number of members in an LLP, and how many were reporting as two member LLPs, based upon the partnership returns filed. Unfortunately, whilst HMRC confirmed that this information was held by them, the request was denied on the basis

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471 Companies House, *Statistical Tables on Companies Registration Activities 2019-20* https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2019-to-2020> accessed 1 April 2022.

472 Companies House, *Statistical Tables on Companies Registration Activities 2013-14* <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/380779/CompaniesRegisterActivities2013-2014.pdf> accessed 19 April 2022. The author was unable to find figures dating back to the 2001 when the LLP was first introduced.

473 The precise figures in relation to the number of LLPs are as follows: 2013-14 - 56,121; 2014-15 - 56,129; 2015-16 - 56,622; 2016-17 – 55,552. Extracted from Companies House *Statistical Tables* (ibid).

474 Companies House, *Companies Register Activities: 2019 to 2020* <https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2019-to-2020/companies-register-activities-2019-to-2020> accessed 1 April 2022.

475 ibid.

that 'HMRC would not be able to identify all the information requested as it is not readily available and would require a great deal of manual processing and intervention'.[476] Accordingly, there is no further accessible data on this point.

3.4 THE LLP AND THE OWNER-MANAGED BUSINESS

In 2013,[477] Fletcher, Frecknall-Hughes and Williams published the LLP Report exploring the relationship between the LLP and the small and medium-sized business sector. The study is the only one to date that analyses the use of the LLP by reference to firm size. The main stages of research[478] were undertaken during mid-2011, a year involving a (rare) increase in the number of ordinary partnerships (both in real terms and as a percentage of the business population).[479] Understandably, the age of the study might be seen as a reason to question its utility in accounting for the decline in the use of ordinary partnerships in more recent years, but it is nonetheless the case that the demise of the ordinary partnership was already underway at the time the research was conducted. An early insight is no doubt useful, even if the data might not carry as much weight today as it once did. The fact that the main stages of research were conducted during a year of increase in the number of ordinary partnerships also need not be of concern. The findings of the fourth stage of research (the responses to a despatch of a questionnaire to 3,500 LLPs) are the most relevant for the purpose of ascertaining why the use of the ordinary partnership might be in decline. Crucially, the fourth stage of research did not focus on LLPs established *only* in the period where ordinary partnerships saw a short-lived

476 Letter received 3 October 2018. The cost limit was deemed to equate to one person spending 3.5 working days locating and extracting the information.

477 The analysis is primarily based on figures obtained in May 2011.

478 LLP Report (n 36) 13, outlines the research stages.

479 Business Population Estimates 2011 (n 7).

resurgence in their use, but across the whole of the 2001-2011 period which reflects an overall downwards trend in the use of ordinary partnerships.[480] The LLP Report therefore provides a rich source of data to be considered and as such it receives detailed consideration in this Chapter.

3.4.1 LLP Report Findings

The LLP Report presents a generally positive view on the suitability of the LLP as a business form for small and medium enterprises. Analysis of the Financial Analysis Made Easy ("**FAME**") database indicated that a significant proportion of LLPs were operating with just two partners (69.7% of all active LLPs without a balance sheet total),[481] though in some instances, even with 'very small' LLPs, one of the partners was a corporate member thereby suggesting some more complex business configurations than the standard partnership.[482]

In relation to sectoral use, one of the main conclusions of the LLP Report was that:

> [i]t is commonly perceived that the new form of the LLP is distinctive in that it affords a measure of protection akin to that provided to shareholders of limited liability companies. In practice, however, the LLP has become a legal vehicle that is accessible and appealing beyond accountancy and professional firms. In particular, the LLP form has become attractive…in that it provides more

480 See National Archives, Department for Business Enterprise, *Enterprise Directorate: Small and Medium Enterprise Statistics for the UK and Regions*, 2011 <http://webarchive.nationalarchives.gov.uk/20110907102150/http://stats.bis.gov.uk/ed/sme/index.htm> accessed 23 March 2022, for reports dating back to 1999.

481 LLP Report (n 36) 18. 'Small' LLPs are generally exempt from filing balance sheet totals with the Companies House.

482 LLP Report (n 36) 34. Not all of the respondents appeared to understand why the LLP had been structured as such: '…one respondent explicitly ask[ed] "what the hell is a corporate member?" Overall, there was a varying range of sophistication in terms of the use of corporate members, suggesting on the one hand a considerable level of expertise or professional advice as to their use, but on the other total unawareness of their existence or potential.'

> protection than a standard partnership and avoids some of the reporting requirements of incorporation…

The Report further analyses the classification of LLPs, by reference to businesses type, in the FAME database (Figure 88).[483]

[483] LLP Report (n 36) 19, 64. The authors of the LLP Report found the exact sectoral distribution difficult to assess because LLPs are not obliged to identify their Standard Industrial Classification (SIC) code when returns are sent to the Companies House. The results were therefore ascertained by using key word searches.

Figure 88: LLP Report Classification of LLP business type

Table 8: Classification of LLPs in FAME by reference to business type

property	1,786	production	184	contractor	52
investment	1,499	energy	178	oil	52
service	1,395	tax	173	orthodontic	46
capital	1,244	health	173	photo	45
manage	1,229	construction	162	publish	42
solution	717	engineer	145	plumb	40
finance	709	planning	141	distribution	40
trading	478	training	133	transport	39
trade	473	marketing	131	child	35
estate	438	sport	109	pension	34
solicitor	408	electric	108	restaurant	31
consultant	345	music	106	chemicals	30
adviser	334	logistics	97	furniture	27
architect	293	clinic	95	metal	25
venture	283	marine	92	automation	25
farm	258	equity	90	equestrian	20
asset	252	survey	81	security	19
international	246	food	80	advert	19
technology	206	clean	79	manufacture	18
account	197	recruitment	77	doctor	14
film	196	resident	75	plaster	11
industry	186	environment	65	agriculture	4
build	185	motor	64		

NB: 15,103 LLPs classified out of a total 42,156.
Date of retrieval: 24 May 2011.

Out of the total 15,103 LLPs that could be classified 51.6%[484] can be regarded as forming part of the professional sector,[485] 14.7%[486] are associated with real estate activities[487] and 18.4%[488] are businesses that have ties with traditional forms of trade i.e. non-professional businesses.[489] 3.4%[490] of the LLPs involved trades associated with the construction industry.[491] These figures support the LLP Report's finding that there is a role for the LLP in the non-professional business sector. Whilst the LLP Report does not take the additional step of analysing the relationship between the type of business and size of the LLP, in light of the fact that 69.7% of LLPs without a balance sheet total on the FAME database and 57.2% of 'small'[492] businesses had just two partners it can be inferred that at least some of the non-professional businesses are being operated by owner-managed firms. The LLP Report also noted that only 16.3% of the respondent 'very small' LLPs (those with less than £100,000

484 8,472.

485 Results calculated by adding together figures from the following headings: investment; service; capital; manage; solution; finance; solicitor; consultant; adviser; architect; venture; asset; technology; account; tax; health; marketing; clinic; equity; orthodontic; pension; doctor. Others that might have might have been included but were not because classification was more difficult include: service (which might comprise professional and non-professional businesses); international; film; energy; engineer; planning; training; sport; music; survey; recruitment; resident; environment; publish; child; chemicals; advert.

486 2,224.

487 Results calculated by adding together figures from the following headings: property; estate.

488 2,782.

489 Results calculated by adding together figures from the following headings: trading; trade; farm; industry; build; production; construction; electric; logistics; food; clean; motor; contractor; oil; photo; plumb; distribution; transport; restaurant; furniture; metal; automation; security; manufacture; plaster; agriculture. Others that might have been included but were excluded on the basis that classification was more difficult include: service; international; film; energy; music; marine; chemicals; equestrian; advert.

490 506.

491 Figures include the following headings: build; construction; electric; plumb; plaster i.e. the types of business that have a high failure rate in the early years of operation. Simmons Gainsford Group, 'Limited Liability Partnerships', 2011 <https://www.sgllp.co.uk/limited-liability-partnerships//> accessed 26 March 2022: 'The LLP concept has proved popular so far, especially with the construction industry, pharmacies and garages.'

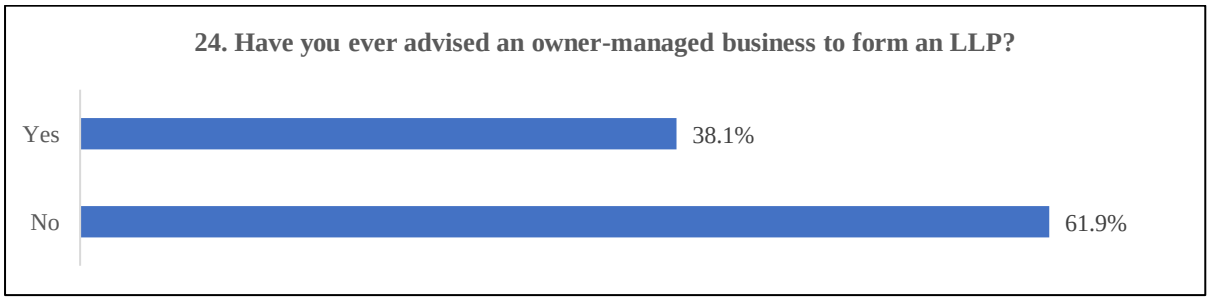
492 'Small' here means businesses with fewer than 50 partners and a turnover of less than £6.5million: LLP Report (n 36) 24.

turnover) operated in legal or accountancy services.[493] This thereby indicates that a fairly significant number of the existing LLPs could be owner-managed, and further be comprised of owner-managed businesses operating in non-professional sectors.

3.4.2 Author's Empirical Research

The author's survey asked the respondents whether they had ever previously advised an owner-managed business to form an LLP. Only a minority (38.1%)[494] confirmed that they had which is substantially lower than the figures provided for both companies (98.6%) and partnerships (74.2%) respectively. The accountants that had previously advised owner-managed businesses to form partnerships were also more likely to have advised the use of LLPs (43.2%[495] as compared to 22%).[496]

Figure 89: Percentage of accountants that have advised an owner-managed business to form an LLP



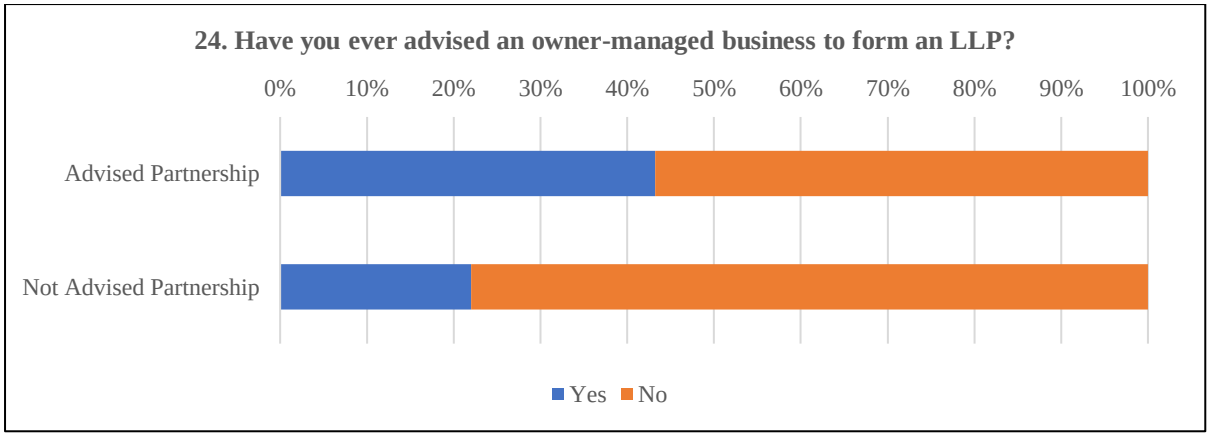
493 LLP Report (n 36) 24.

494 136/357.

495 112/259.

496 20/91.

Figure 90: Percentage of accountants that have advised an owner-managed business to form an LLP, cross-tabulated with experience of having advised an owner-managed businesses to use a partnership



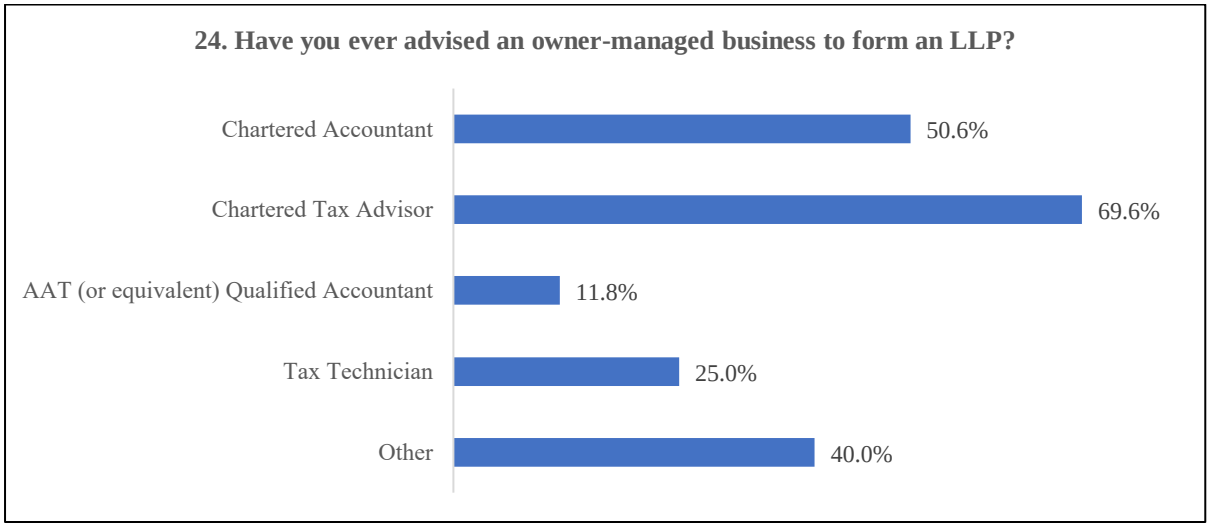
Of course, given the complex nature of the LLP form (explored in more detail at 3.4.4) it may be the case that owner-managed businesses that contemplate operating as an LLP choose to approach a lawyer, rather than an accountant, for assistance. That being said, given the propensity of owner-managers to seek the advice of an accountant in relation to form one might reasonably expect the figures to be higher than those reported. Furthermore, respondents to the LLP Report were 2.5 times more likely to have sought the advice of an accountant rather than a solicitor in relation to the LLP form (80 and 30 respondents respectively).[497]

Respondents to the author's survey in possession of higher-level qualifications (Figure 91) and members of the largest firms (Figure 93) were most likely to have advised an owner-managed business to form an LLP. The survey results also evidence a correlation between the length of practice and likelihood of having advised an owner-managed business to form an

497 LLP Report (n 36) 3.

LLP – ranging from 13.6%[498] in the 1-5 years category to 42.2%[499] for more than 10 years' experience (Figure 92). Assuming that length of time in practice corresponds with an increased number of previous clients, this result is to be expected; the more owner-managers advised, the more likely it is that at least one business will present itself as a suitable candidate for the LLP form.

Figure 91: Percentage of accountants that have advised an owner-managed business to form an LLP, by reference to qualification[500]



498 3/22.

499 127/301.

500 Yes answers.

Figure 92: Percentage of accountants that have advised an owner-managed business to form an LLP, by reference to experience[501]

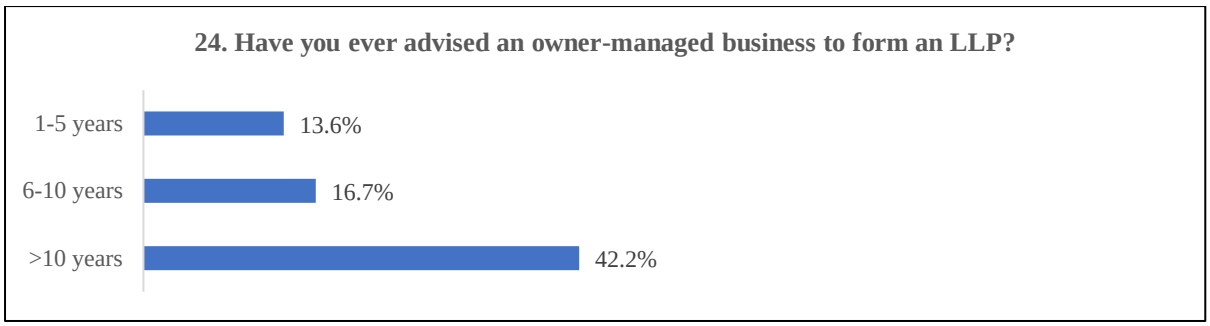
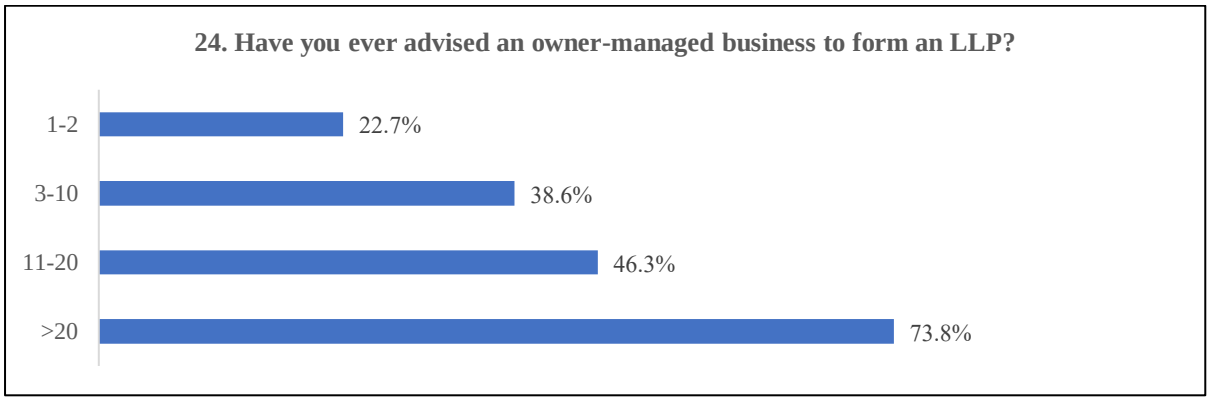


Figure 93: Percentage of accountants that have advised an owner-managed business to form an LLP, by reference to firm size[502]



If broken down by reference to industrial sector, the author's findings evidence a more stark contrast between LLP usage in the professional and non-professional firms than that contained in the LLP Report.[503] 81.6%[504] of the author's respondents had advised owner-managers in the professional, financial and technical services sector to form an LLP, as had a

501 Yes answers.

502 Yes answers.

503 (n 36).

504 111/136. 30% higher than the LLP Report (n 36).

further 33.8%[505] in relation to real estate activities. By way of comparison, the mean figure across the trade sectors[506] was just 8.4%. This is 10% down on the LLP Report statistics, though it is worth noting that the construction sector registered a relatively high percentage (17.6%)[507] which reflects the high-risk nature of the industry. In any event, the 73.2% differential – or 64% if taking the construction industry as a base figure - between the professional and trade sectors is noteworthy and suggests that the LLP has not generally found favour outside of its profession-based target audience.[508]

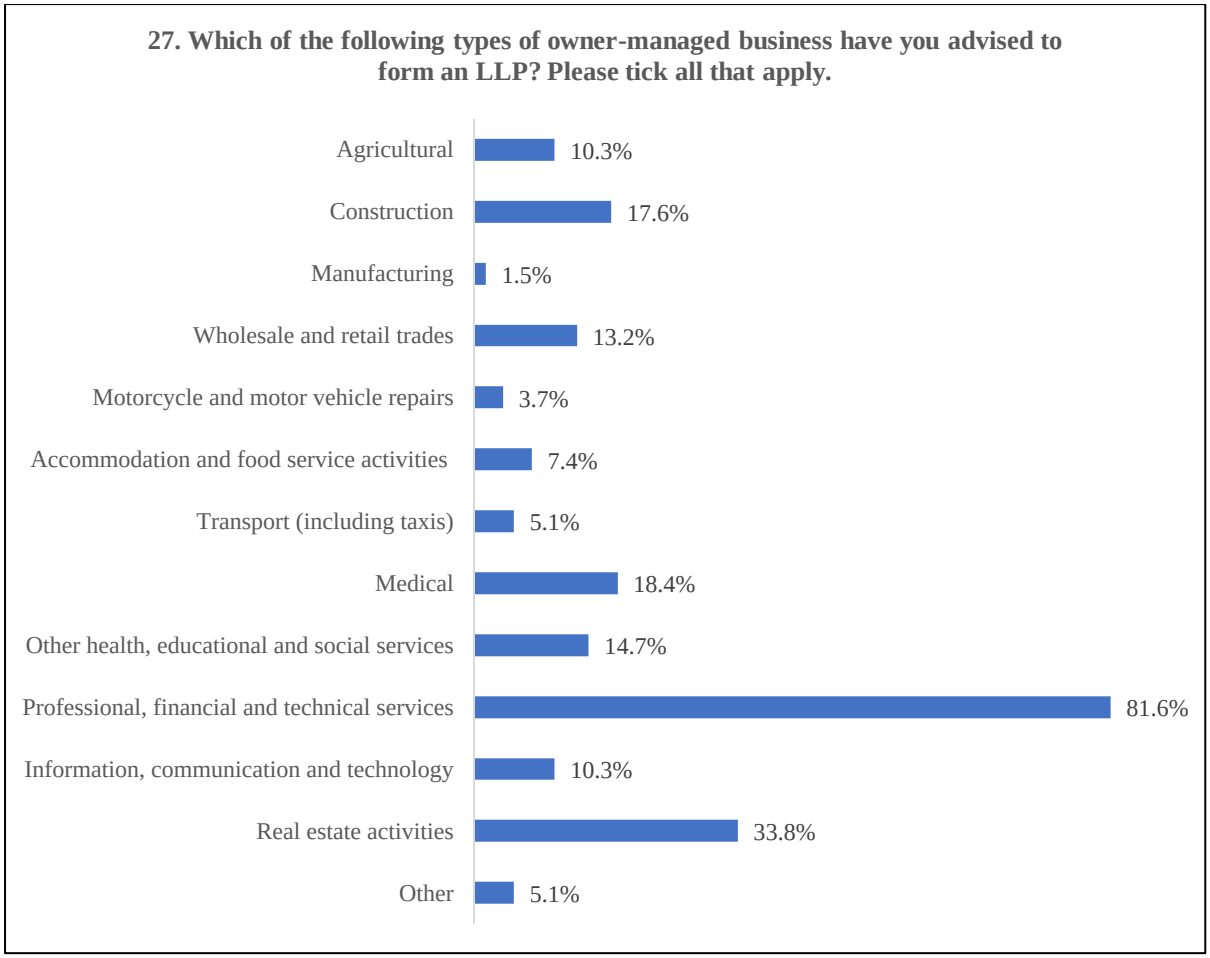
505 46/136. 19.1% higher than the LLP Report (n 36).

506 Results calculated by adding together figures from the following headings: agricultural; construction; manufacturing; wholesale and retail trades; motorcycle and motor vehicle repairs; accommodation and food service activities; and transport (including taxis). These categories were deemed analogous to those grouped for the purposes of analysing the LLP Report (n 36).

507 24/136. 14.2% higher than the LLP Report (n 36).

508 Members of the medical profession may be prevented from using the LLP form where they are reliant upon NHS contracts for business. An LLP is not able to acquire General Medical Services and Personal Medical Service contracts; companies can acquire such contracts so long as strict criteria are met. For more information see Robertson (n 425).

Figure 94: Percentage of accountants that have advised an owner-managed business to form an LLP, by reference to industrial sector[509]



The survey further explored the advantages and disadvantages of the LLP which may affect the choice of form for owner-managed businesses. The accountants were asked the extent to which they agreed that the following were advantages of operating as an owner-managed LLP:[510]

509 7/136 selected 'Other' as part of their response. The following were listed as part of that category: leisure; litigation funding LLPs, design and architects (though this could form part of the 'professional services' heading); entertainment, media and arts; licensing; any with a risk business; not for profit organisations.

510 The respondents were also offered 'ability to satisfy customer/industry requirements' as a possible advantage of the LLP form. This is not discussed in any further detail owing to the fact that the author was unable to identify any clear cases where operating as an LLP was typically a condition of doing business. Furthermore, only 42.4% (135/318) of the participants agreed that this was an advantage for owner-managed businesses; 42.1% (134/318) disagreed and 15.4% (49/318) selected 'don't know'. In

- Limited liability;
- Separate and continuing legal personality;
- Flexible business structure;
- Ease of partner movement (in and out);
- Privacy;
- Degree of personal control;
- Tax treatment.[511]

Upon analysis of the original data set, the author noticed a mistake in the original survey. When asked in relation to the advantages of LLPs the response options were presented in the form of 'very important', 'important', 'not important' and 'don't know'. The questions in relation to disadvantages matched the form provided elsewhere in the survey. For the purposes of analysis, the author translated the advantages options as follows:

- Very important = strongly agree;
- Important = agree;
- Not important = disagree.

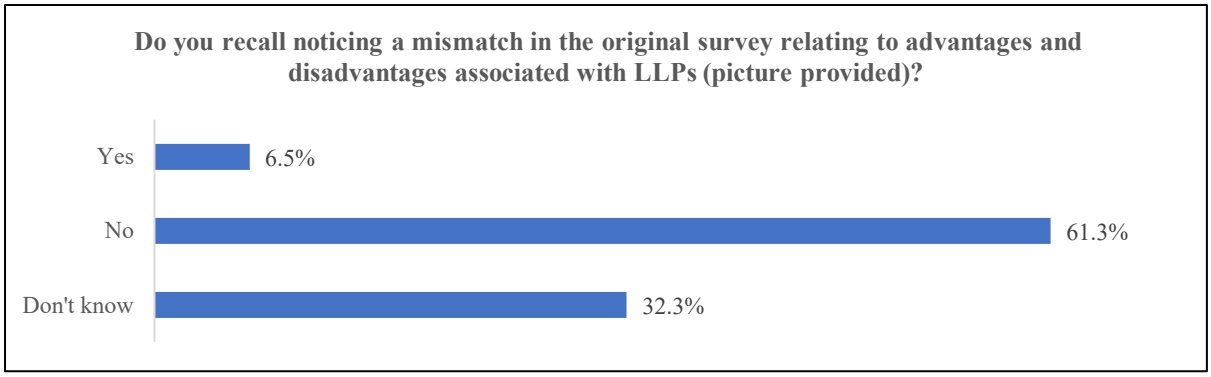
To obtain a more complete picture in relation to the possible effect of the mistake, the author circulated a follow-up survey to 57 respondents that provided their email addresses at

the follow-up version, 22.6% (7/31) agreed, 41.9% (12/31) disagreed and 12.9% (4/21) selected don't know.

511 Again, tax treatment is excluded from consideration in this Chapter, and is addressed fully in Chapter 4. No other notable advantages were provided by the respondents as part of the free text option.

the end of the original study. They were presented with the question in the intended form and were also asked to recall whether they noticed the mistake. 31 responses were received. 6.5%[512] noticed the mistake; the majority (61.3%)[513] did not (Figure 95).

Figure 95: Percentage of respondents that recall a mistake in the original survey



The author's additional data is presented alongside the translated data in the following sections. The general tenor is that the follow-up results in relation to the commercial considerations are broadly in line with the position derived from the interpretation of the original data set, though personal control and privacy are outliers in this respect.[514]

3.4.2.1 Limited Liability

The benefits and limitations of limited liability were explored in detail in Part 2.2.1, and the observations therein are equally applicable to LLPs.[515] Limited liability may be curtailed by

512 2/31.

513 19/31.

514 On the issue of personal control, the follow-up produced a figure 20.8% lower than the original survey, resulting in overall disagreement. In relation to privacy, the updated responses also tipped the balance into disagreement (-10.3%). However, the original response was not overwhelmingly in favour of the LLP form on this latter point (52.3% agreed in the first survey). See Chapter 4 for the differential in the tax perspective, which is the most disparate result.

515 Morse (n 12) 359-360: 'A individual member's personal liability for his or her own negligence whilst acting on behalf of the LLP will be a matter for the courts to determine, by analogy with the direct liability of a director as set out by the House of Lords in *Williams v Natural Life Foods Ltd* (n 97). The

the operation of section 4A LLP Act 2000, which applies where an LLP carries on business without having at least two members for more than 6 months.[516] In this case, the remaining member, who knows that the LLP is carrying on business with only one member, becomes jointly and severally liable for the payment of the LLPs debts contracted thereafter.[517] In the case of an owner-managed business, the knowledge requirement will almost certainly be satisfied; the membership will normally fall to one as a result of death, divorce or disagreement.[518] In the event that the LLP membership falls to one, the remaining member has a number of options that would enable him/her to retain limited liability. The first is simply to find another person to subscribe to the incorporation document – the addition of a new member appears to be regarded as a simple process by small business owners.[519] Alternatively, they might set up a company that can become a member, though if this structure is used to attempt to achieve tax advantages the anti-avoidance provisions contained in the Finance Act 2004 ("**FA 2004**") will apply.[520] Otherwise, the LLP could be converted into a company, incurring

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question is whether the member has assumed personal responsibility for the matter…. Unless all matters are seen to be by and with the LLP there is a real risk of direct personal liability. Members are unlikely to be personally liable for torts committed by the LLP or other members (as joint tortfeasors) unless the authorized or procedure the commission of the act in question i.e. they committed a wrongful act.'

516 When the LLP Act 2000 was first passed, there was nothing on the face of the Act indicating the consequences of membership falling to one for more than six months. One instead had to look at CA 1985, s 24 as amended by LLP Regulations 2001, SI 2001/1090, Sch 2, which Freedman described as a 'trap for the unwary': Freedman JCL (n 98) 909. The discovery issue was remedied by the LLP Regulations 2009, SI 2009/1084, Reg 2(3), Sch 3, para 3), inserting s 4A into the LLP Act 2000.

Under IA 1986, s 122(1) a single-member LLP can be wound up by the Court. By virtue of CA 2006, s 156 the Secretary of State has the power to issue a directive to a one-person LLP to rectify the situation within a maximum of three months. A failure to comply is a criminal offence resulting in fines calculated on a daily basis (CA 2006, s 156(7)).

517 LLP Act 2000, s 4A(2).

518 It is also important to bear in mind that, particularly where there is no succession plan in place, a number of small businesses partnerships would choose to cease trading where there is a significant change in circumstances such as this: OTS Small Company Taxation Review (n 40) 9.

519 LLP Report (n 36) 65.

520 Inserting ss 850C-E into ITTOIA 2005. One way to avoid this is to ensure that all of the profits and losses are allocated to non-corporate member. On other avoidance mechanisms see: Iain Robertson, 'All Mixed Up', *Taxation*, 22 January 2014.

minimal tax charges if the conditions of section 162 TCGA 1992 (incorporation relief) are met.[521] Finally, the LLP might be dissolved, and a new private company established. Professional advice would be beneficial to effect the above suggestions.

There is also an apparent threat to the limited liability of LLP in the event of a conversion from an ordinary partnership. In the House of Lords' debate on 9 December 1999, Lord Goldsmith warned that in certain circumstances an LLP may continue to be treated as a partnership with the consequence that limited liability might be lost. He stated: [522]

> [i]f people choose to incorporate as a limited liability partnership, but carry on business as if they were still in partnership of the kind people are used to – a partnership where the assets and integrity of the individuals are at stake – I predict that they will find that the courts may say "though you have incorporated, you are carrying on a business together". I suggest that the courts need to be vigilant to make sure the great privilege of limited liability…continues to carry with it the great responsibility, which includes the provisions that the members of the public know whom they are dealing with.

Rowlands and Zeider comment:

> [t]his is a strong message which suggests that members must be scrupulous in their dealings with other members as well as third parties to make sure that no indicia of partnership are ever present in documentation (LLP constitutional documents, business cards and notepaper, trading names etc.) or in a way that the members are held out or more generally comport themselves. *That said*, former partners in professional firms that have converted to LLP status generally continue to refer to themselves as partners rather than members, albeit with notes in websites and formal documents to the effect that their true status is that of members of an LLP, *and this does not seem to be causing any problem in practice*.[523]

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521 Discussed in more detail in Chapter 4.

522 Rowlands and Zeider (n 434) 36.20.

523 Rowlands and Zeider (n 434) 36.20. Emphasis added. See also Lindley and Banks (n 164) 10-328.

Accordingly, members should be careful to ensure that the constitution and other documents respect the separate identity of the LLP and that the members will not, *in general* undertake any personal liability for the debts and obligations of the LLP. Beyond the need for these formalities,[524] Lord Goldsmith's warning should not be a cause for too much concern.[525]

The LLP Report asked respondents to provide details about the establishment of their LLPs including whether they were originally set up as LLPs or converted from some other legal form.[526] The conversion element is particularly important; if there is a decline in the use of the ordinary partnership, combined with evidence that a significant number of owner-managed businesses are converting from ordinary partnerships to LLPs, the correlation could be used to support the claim that the decline is genuinely attributable to the pursuit of limited liability (this being the fundamental difference between the two business forms). The LLP Report published 12 comments on reasons for conversion to an LLP: [527]

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524 See Lindley and Banks (n 164) 10-328. The signing of separate personal guarantees should not lead to legal personality being disregarded.

525 In the event that members fail to draft an LLP agreement, there are a limited number of default provisions contained in the Limited Liability Partnerships Regulations 2001, SI 2001/1090, Regs 7 and 8. The provisions are based on the PA 1890 ss 24, 25, 28-30. The provisions are sparse when compared to the general law governing partnerships and the default provisions for companies contained in the Companies (Model Articles) Regulations 2008, SI 2008/3229. McCahery, Vermeulen and Priydershini (n354) describe the provisions as 'flimsy'. *Hailes v Hood* [2007] EWHC 1616 (Ch) highlights the problem that the default provisions failed to provide for how LLP assets are to be divided when a member leaves: case discussed by Peter Gary and Troy Wano, 'Way out quest', *The Lawyer*, 22 October 2007, 28. LLP Act 2000, s 15(c) contains a power that could be used to extend the general law provisions applicable to partnerships to LLPs, but this has not been exercised. It was originally proposed by the DTI that the default rules and principles applicable to ordinary partnerships would be applied to the LLP, but this was rejected on the basis that it might give rise to unexpected problems and inappropriate results when applied to the LLP: Palmer's LLP Law (n 434) A5-12.

526 LLP Report (n 36) 25.

527 LLP Report (n 36) 27.

Figure 96: LLP Report reasons for conversion from partnership to LLP

'I didn't want to be handling dividends. I didn't want to be having to deal with all the national insurance side. If one is perfectly honest, we kept things slightly below the radar zero limit.' (LLP 004)

'We changed …'because of the limited liability as there was a significant amount of corporate debt within the business.' (LLP 005)

'It has advantages in terms of the limited liability element to it.' (LLP 007)

'There was the limitation of liability that was a key commercial consideration, although we have obviously got professional indemnity insurance we didn't want to be jointly and severally liable for our debts.' (LLP 008)

'Limited liability, which is the prime benefit. I think we thought the other benefit was that it gave us a slightly more corporate structure for running our business.' (LLP 009)

'LLP rather than a conventional partnership simply because of the need to protect against unlimited personal liability.' (LLP 010)

'The most pressing I suppose was the limited liability status.' (LLP 011)

'At the time they thought it would mean paying less tax.' (LLP 015)

'Save money on insurance especially indemnity insurance and dealing with revenue and customs it was altogether much easier. It is a nice legal relationship which builds on our personal relationship so it kind of works.' (LLP 017)

'It was succession planning to allow new partners to come in. Liability for us is a huge issue so that would definitely have been a driver had we not already had been a limited company.' (LLP 018)

'We wanted the limitation of liability as opposed to just a partnership so we liked the limitation of liability aspect of it.' (LLP 019)

'I think the limited liability.' (LLP 020)

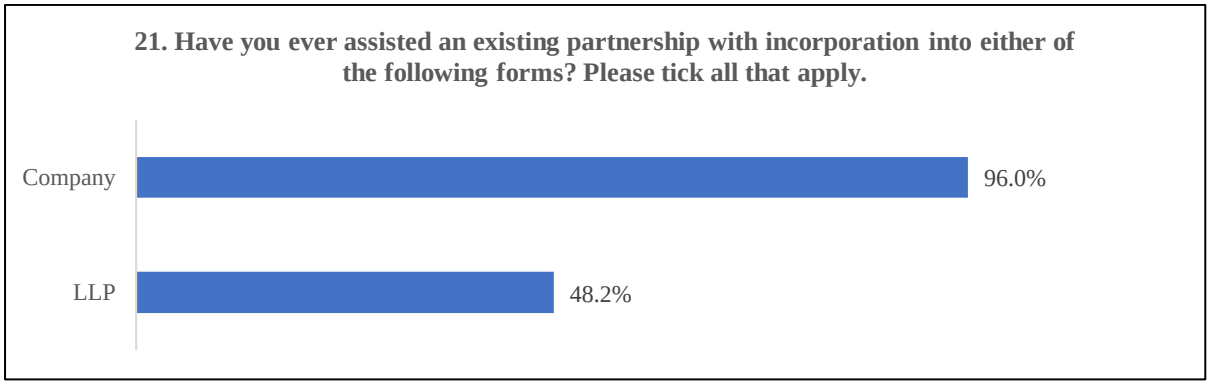
It is noteworthy that most of the responses indeed cited limited liability as the driver of conversion. If this is a representative sample,[528] then it could be inferred that for a significant number of converting businesses limited liability is the, or certainly one of the most important, reason(s) for converting to an LLP. However, just 14%[529] of the respondent 'very small' LLPs, as compared with 42% of the overall sample, indicated that they had converted to an LLP from

528 The sample size is very small, and so one must be careful not to place too much reliance on the responses. It also isn't clear from the LLP Report whether the published responses are all of those provided, or a selected sample nor is there a breakdown of reason provided by reference to business size.

529 6/43.

a different business form. Only 2 respondents (4.7%) claimed to have converted from an ordinary partnership, meaning that the majority of respondents were actually switching between two *corporate forms* with limited liability. Overall, the LLP Report data suggests that conversion from partnership to LLP by owner-managed businesses is relatively uncommon (though the case for businesses with a turnover between £100,000 and £1,000,000 is stronger). Furthermore, the author's empirical research indicates that partnership-LLP conversions are less frequent than partnership-company conversions. Only 48.2%[530] of the respondents had assisted an existing partnership with an LLP conversion (as compared to 96%[531] assisting company conversions).[532]

Figure 97: Percentage of respondents advising partnership conversions to LLPs and companies[533]



530 109/226.

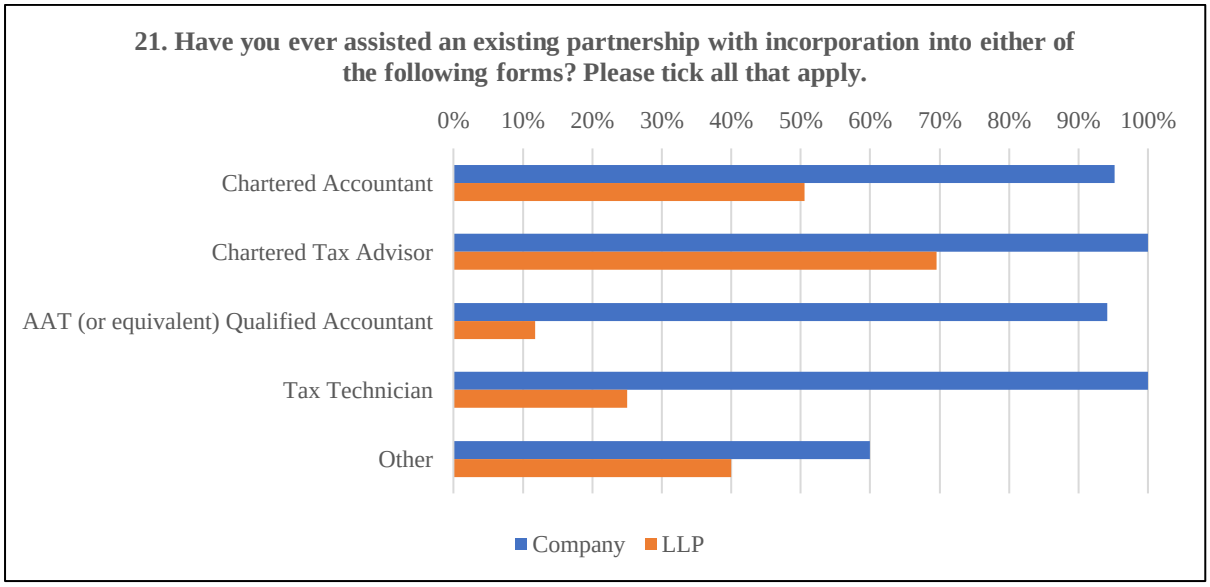
531 217/226.

532 It is possible that a lawyer is approached more frequently than an accountant for conversion assistance, yet the difference between LLPs and companies in the author's data is striking.

533 Percentage of respondents based on number of people who viewed the question. This question was not available to those who had not advised an owner-managed business to form/operate as an ordinary partnership.

The cross-tabulated responses highlight that the respondents with higher level qualifications were more likely to have assisted with partnership-LLP conversions (Figure 98); a 69.6%[534] majority of Chartered Tax Advisors, and 50.6%[535] of Chartered Accountants had assisted with a partnership-LLP conversion, compared to just 11.8%[536] of AAT (or equivalent) qualified accountants. The results also evidence that respondents with 6-10 years' experience were significantly less likely than their counterparts to have assisted with a partnership-LLP conversion (just 20%)[537] (Figure 99). Individuals in the largest firms were most likely to have advised a partnership-LLP conversion (Figure 100).

Figure 98: Percentage of respondents advising partnership conversions to LLPs and companies, by reference to qualification



534 17/24.

535 99/196.

536 3/27.

537 2/10.

Figure 99: Percentage of respondents advising partnership conversions to LLPs and companies, by reference to experience

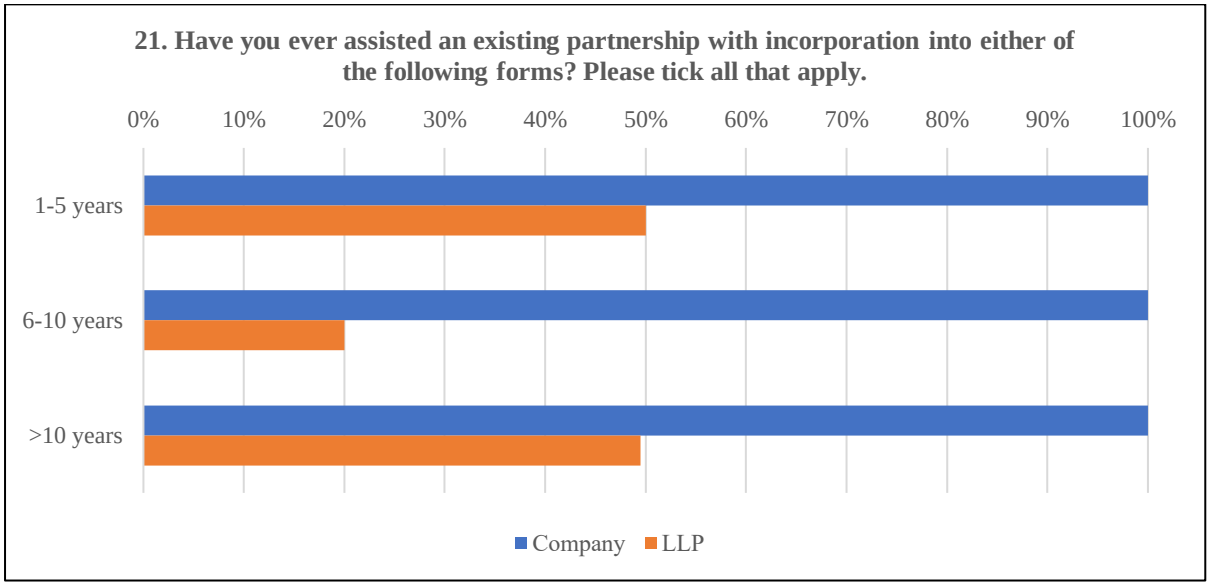
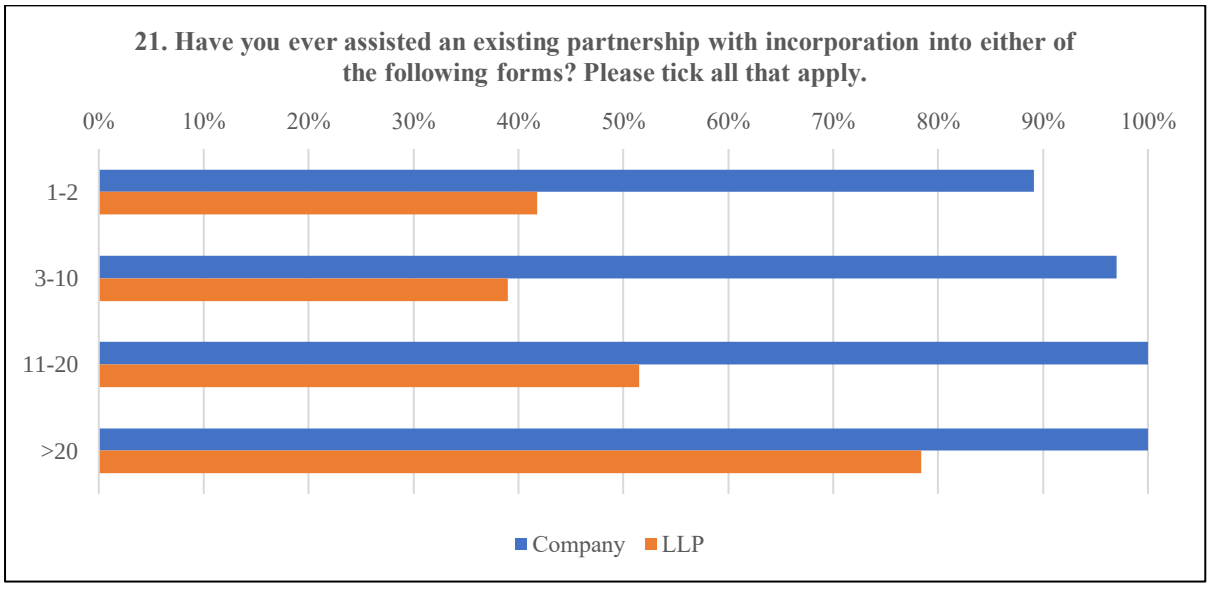


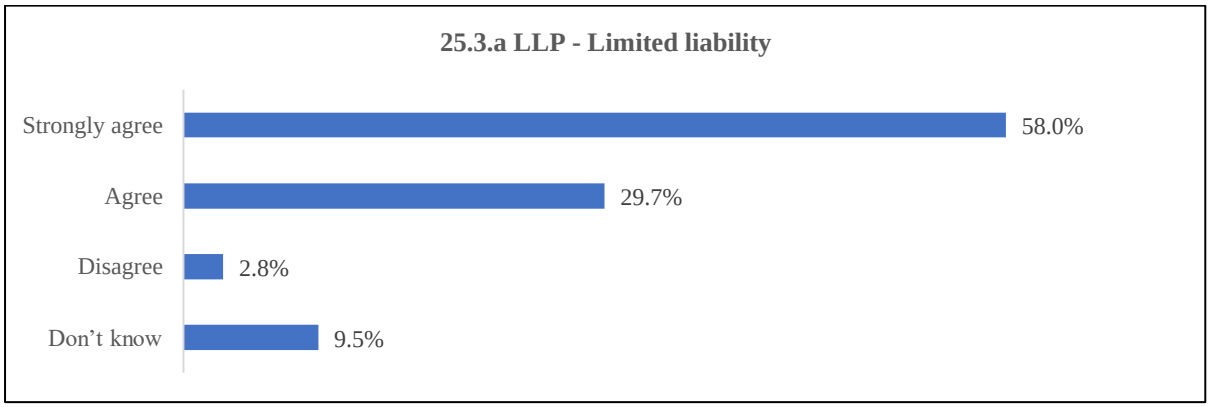
Figure 100: Percentage of respondents advising partnership conversions to LLPs and companies, by reference to firm size



Another possibility is that the ordinary partnership has been slowly phased out as a result of *new* owner-managed businesses, focused upon acquiring limited liability, adopting

the LLP as the preferable form. Indeed, 86%[538] of the LLP Report respondents that were classed as 'very small' indicated that they had started as LLPs. Yet, in this instance, limited liability was not the most commonly cited reason by the LLP Report respondents.[539] Still, that does not mean that limited liability is an insignificant consideration for non-converting owner-managed LLPs. An overwhelming majority (87.7%)[540] of the respondents to the author's survey indicated that limited liability was an advantage of forming/operating as an LLP for an owner-managed business. However, this was not as high as the company-based response (98.4%) and a noteworthy proportion (9.5%)[541] responded with 'don't know' to this particular question.[542] Overall, this ranked first in the list of advantages presented to the respondents.

Figure 101: Agreement that limited liability is an advantage of the LLP[543]



538 37/43.

539 Tax reasons ranked highest in this instance.

540 278/317.

541 30/317.

542 The percentage of 'don't know' responses to all of the LLP questions was significantly higher than with both companies and ordinary partnerships.

543 Cross-tabulated data has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

In terms of the overall level of agreement (90.3%),[544] the results produced by the follow-up survey were broadly similar.

Figure 102: Agreement that limited liability is an advantage of the LLP (v2)



Clearly, notwithstanding its limitations, limited liability is regarded as a significant advantage of the LLP. Its availability ostensibly makes the LLP an attractive choice for owner-managers, especially when combined with the additional advantages considered below.

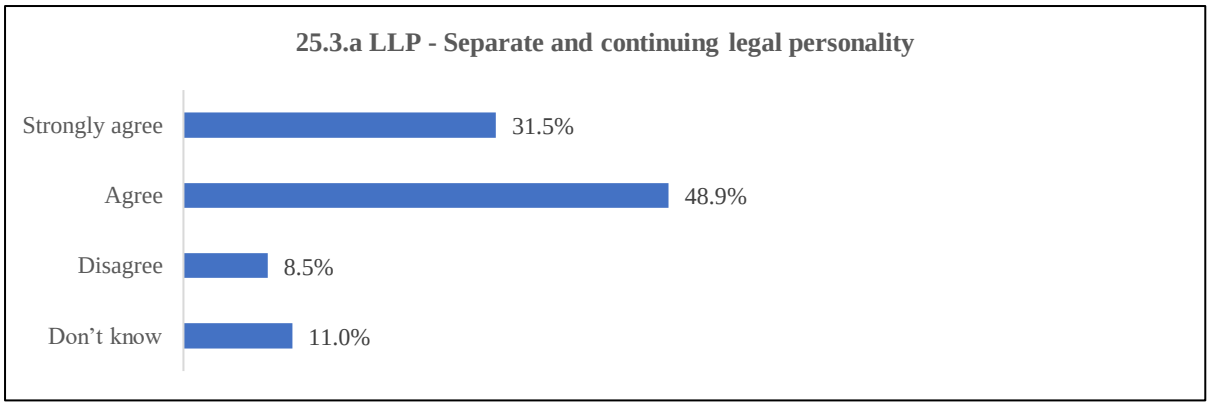
3.4.2.2 Separate Legal Personality

Section 1(2) LLP Act 2000 endows the LLP with legal personality. The benefits mirror those attaching to the company explored in Part 2.2.2. As anticipated, a high proportion (80.4%)[545] of the respondents to the author's survey agreed that this was an advantage of the LLP form for owner-managed businesses, though the overall figure was lower than that for companies (95%).

544 28/31.

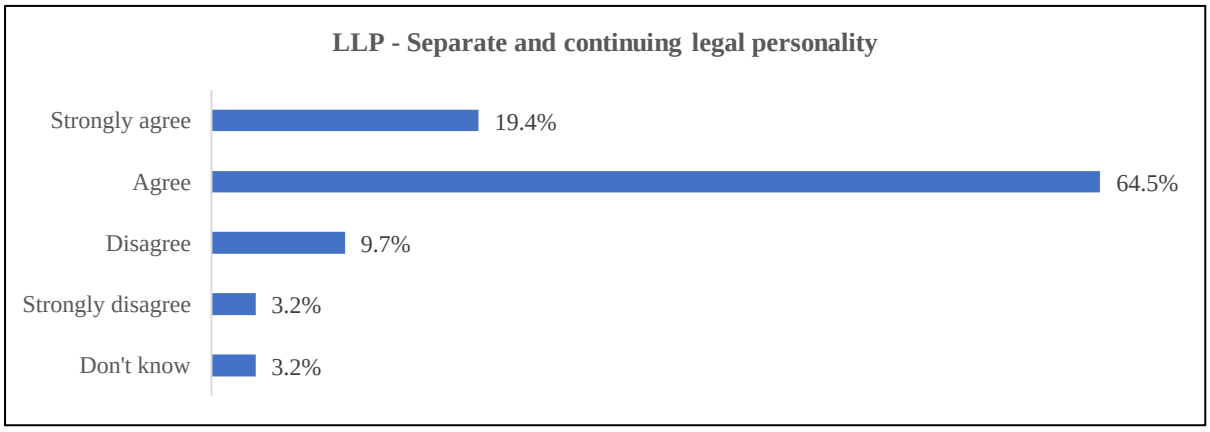
545 255/ 317.

Figure 103: Agreement that separate legal personality is an advantage of the LLP[546]



Legal personality ranked second highest in the list of prompted advantages for the LLP form; given the close link with limited liability this result was broadly anticipated. A similar result was produced by the follow-up survey.

Figure 104: Agreement that separate legal personality is an advantage of the LLP (v2)



546 Cross-tabulated data has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

3.4.2.3 Ease of Partner Movement (In and Out)

The fact that LLP members can join and depart without destroying its legal existence can make membership change a more convenient affair than is the case with the ordinary partnership. Any person may become a member of an LLP by and in accordance with the agreement of any existing members.[547] In this respect, the LLP provisions mirror partnership law, though the Companies House will need to be updated upon the admission of a new member.[548] One distinct feature of the LLP arises from section 4(3) LLP Act 2000. The provision states that '[a] person may cease to be a member of a limited liability partnership (as well as by death or dissolution) in accordance with an agreement with the other members *or, in absence of agreement with the other members as to the cessation of membership, by giving reasonable notice to the other members'*.[549] Where a person ceases to be a member, notice must be delivered to the Registrar within 14 days,[550] and the Companies House will need to be informed.[551] Accordingly, membership is always at the will of the member,[552] though Morse warns that unilateral

547 LLP Act 2000, s 4.

548 This can be done by sending form LA 1P01 to the Companies House, or online via the following link: <https://www.gov.uk/government/publications/appoint-a-member-of-a-limited-liability-partnership-ll-ap01> accessed 3 April 2022.

549 Emphasis added.

550 LLP Act 2000, s 9(1)(a). Other statutory forms of cessation are provided for in LLP Act 2000, s7 and include: death; bankruptcy, sequestration or winding up of the estate; the granting of a trust deed for the benefit of creditors; the assignment of the whole or part of a share in the LLP (absolutely or by way of charge or security). Morse and Braithwaite (n 12) 412: 'the scope for dispute in a contentious resignation is obvious, as is (as it always is) what qualifies as 'reasonable'. In the latter regard, a reasonable notice period is intended to strike a balance between the competing rights of the individual seeking to leave the business and those that remain; consequently case law on reasonable notice in the employment context is likely to be relevant, and the courts can be expected to take a similar approach. Key considerations would therefore likely include the seniority of the member, their role in the organization and length of involvement in the business, and the nature of that business.'

551 This can be done by sending form LL TM01 to the Companies House, or online via the following link <https://www.gov.uk/government/publications/terminate-appointment-of-member-of-a-limited-liability-partnership-ll-tm01> accessed 19 April 2022.

552 Furthermore, LLP Regulations 2001, SI 2001/1090, Reg 8 provides that: 'No majority of the members can expel any member unless a power to do so has been conferred by express agreement between the members.' This effectively applies PA 1890, s 25.

withdrawal 'confers no consequent right on the member to have his or her share bought out either by the LLP or the other members'.[553] By way of comparison, under partnership law a unilateral withdrawal can be ousted by the partnership agreement meaning that where there is disagreement, the individual concerned may still be tied to the partnership and continues to be liable as a partner.[554] In order to disassociate themselves with a company, the owner-manager will need to abandon their position(s) of director/shareholder and comply with the relevant formality rules in doing so. As a general rule, a director can unilaterally resign at any time, simply by giving notice to the company, though the company's articles of association and the director's contract of service may specify terms for retirement or resignation.[555] The position in relation to shares may be more complex, depending upon the reason for departure, and the provisions of the articles of association. Since a company cannot have unallocated shares, the outgoing shareholder must either transfer their shares, by way of sale[556] or gift,[557] to another (this could include a transfer back to the company), or it may be possible for the company itself to force a sale of the shares if the articles so permit. The potential need to deal with the dual

553 Morse (n 12) 352. Where there is an exit dispute, the combined effect of the 2001 (SI 2001/1090) and 2009 (SI 2009/1804) LLP Regulations is to align the right to recovery with the minority protection for shareholders in a company. The two most significant protections are firstly, the right of a member to petition the court for a winding-up order on the basis that it is just and equitable to do so (LLP Regulations 2001, SI 2001/1090, Sch 3, para 1).

554 Though in absence of any ouster, PA 1890, s 26 provides that any partner may determine the partnership at any time on giving notice of his intention to do so to all the other partners. Where the partnership has originally been constituted by deed, a notice in writing, signed by the partner giving it, shall be sufficient for this purpose. There is no writing requirement contained in LLP Act 2000, s 4(3) – by implication, oral notice should suffice.

555 Palmer's (n 56) 8.1313. The TM 01 form is used to update the Companies House of the termination, or it can be done online via the following link: <https://www.gov.uk/government/publications/terminate-an-appointment-of-a-director-tm01> accessed 3 April 2022.

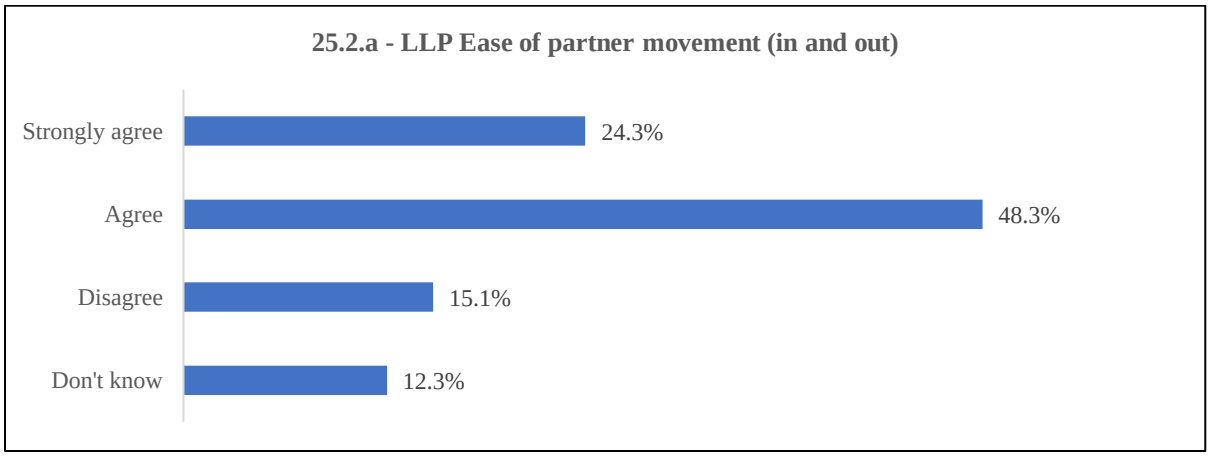
556 CA 2006, s 690 vests a private limited company with a power to purchase its own shares, so long as not prohibited by the company's articles. CA 2006, s 691(1) provides that the shares to be purchased must be fully paid up. Alternatively, the nominal value of the share could be reduced by the unpaid amount via a reduction in capital (CA 2006, s 641(4)(a)).

557 In this case, the formalities outlined in CA 2006, Pt 18 need not be complied with. Nonetheless, the shares must still be fully paid up (CA 2006, s 659(1)).

director-shareholder aspect, and to comply with voting requirements for resolutions makes the company position significantly more complex.

The author's survey results confirmed that the ease of partner movement is regarded as an advantage of the LLP form by the accounting profession,[558] with a 72.6%[559] majority agreeing that this was the case (71%[560] on the follow up – Figure 106), thereby ranking as the third highest prompted advantage.

Figure 105: Agreement that ease of partner movement (in and out) is an advantage of the LLP

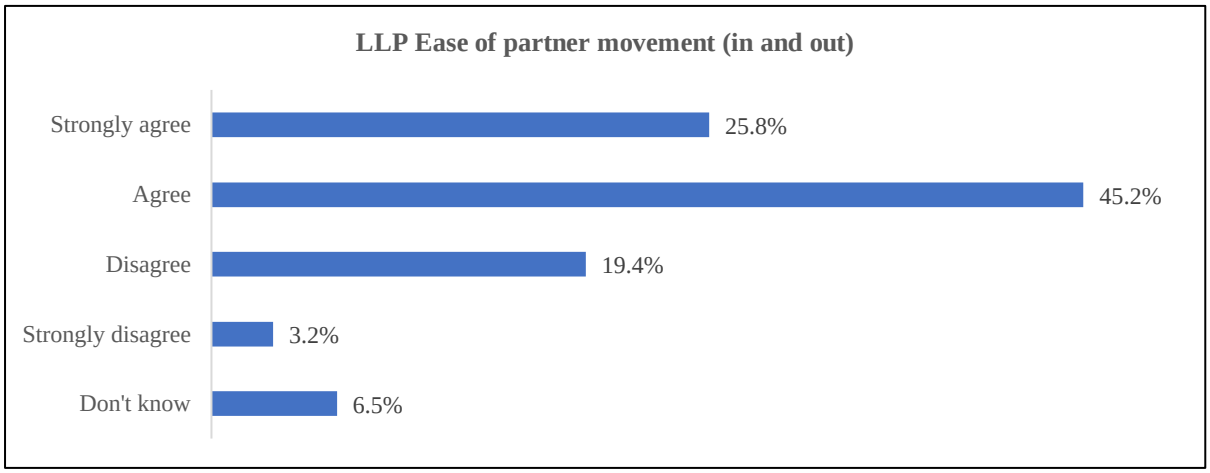


558 One free text response added that 'succession planning would usually be the driver.'

559 230/317.

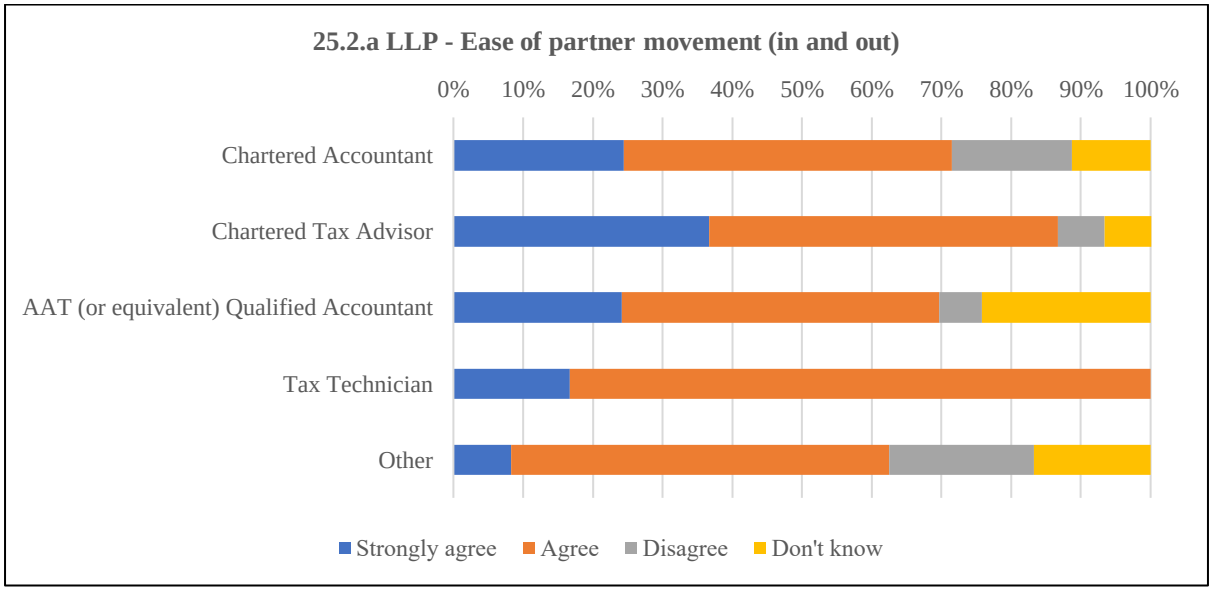
560 22/31.

Figure 106: Agreement that ease of partner movement (in and out) is an advantage of the LLP (v2)



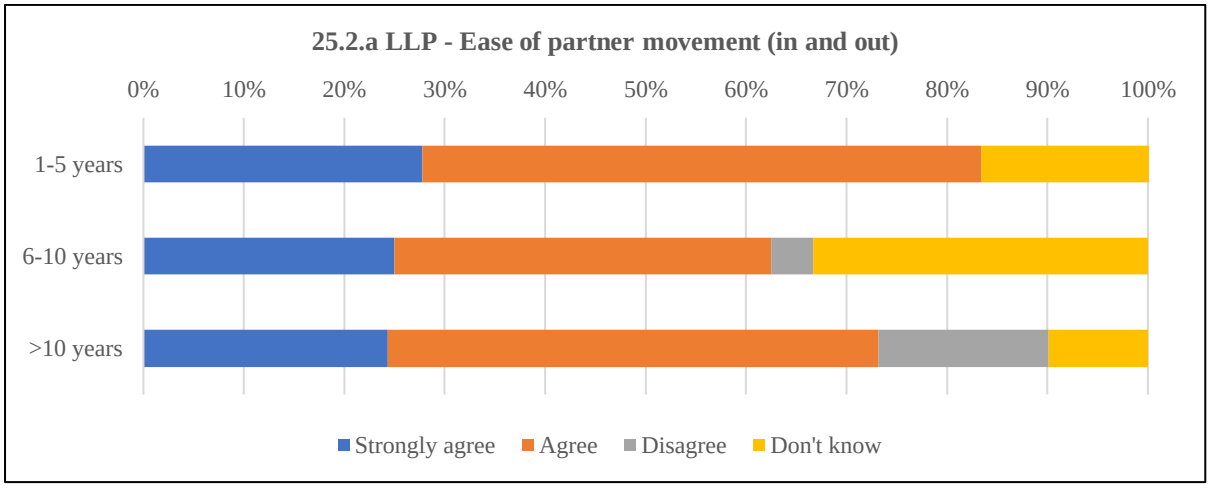
On LLP partner movement specifically, qualification-based analysis produces mixed results with no discernible overall trend (Figure 107).

Figure 107: Agreement that ease of partner movement (in and out) is an advantage of the LLP, by reference to qualification



Throughout the whole of the LLP advantages portion of the survey, the least experienced accountants (1-5 years) were most positive, and the 6-10 years' experience group were the least positive about the purported merits of the LLP form (see, on partner movement, Figure 108). [561] This latter category also consistently returned the highest number of 'don't know' responses. Note, on this point, that this overall more positive stance in the 1-5 years' experience category is not reflected in the likelihood of having advised an owner-managed business to actually form an LLP (Figure 92); this group were in fact *least* likely to have done so.

Figure 108: Agreement that ease of partner movement (in and out) is an advantage of the LLP, by reference to experience



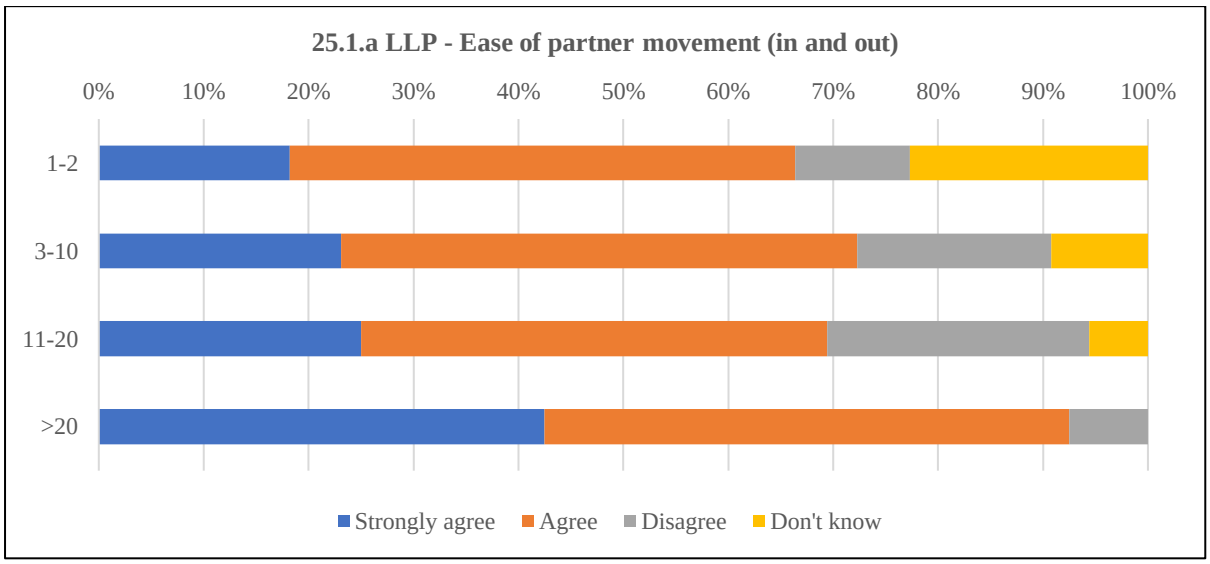
If one looks to potential firm size variations, responses from accountants in the largest firms (more than 20 members) were most positive on the partner movement aspect, and significantly more so than the other groups (92.5%[562] agreed) (Figure 109), though there is no

561 Though cross-tabulated data is still presented where the 5% variation threshold is surpassed.

562 37/40.

perfect size-opinion correlation on this matter (contrast Figure 93 which evidences a clear correlation between size and experience of having advised an owner-managed business to form an LLP). Throughout the advantages section, respondents in the largest firms were always the most positive about the LLP. [563]

Figure 109: Agreement that ease of partner movement (in and out) is an advantage of the LLP, by reference to firm size



3.4.2.4 Flexible Business Structure

The day-to-day running of the LLP is regulated by the LLP agreement, which need not be registered with the Companies House. In this respect, the LLP operates in the same fashion as the ordinary partnership: the agreement is flexible, private, and amended by consent. Accordingly, members have a high degree of autonomy in the regulation of the LLP's internal affairs. It is therefore unsurprising that, notwithstanding the higher levels of 'don't know'

563 Though cross-tabulated data is still presented where the 5% variation threshold is surpassed.

answers (12.9%),[564] a similar proportion of respondents to the author's survey agreed that flexibility was an advantage of the LLP form for owner-managed businesses (71%)[565] as was also the case in relation to partnerships (75.9%). However, this percentage was reduced by 14.6% in the follow-up version of the survey (61.3%[566] agreed) (Figure 111).

Figure 110: Agreement that flexible business structure is an advantage of the LLP

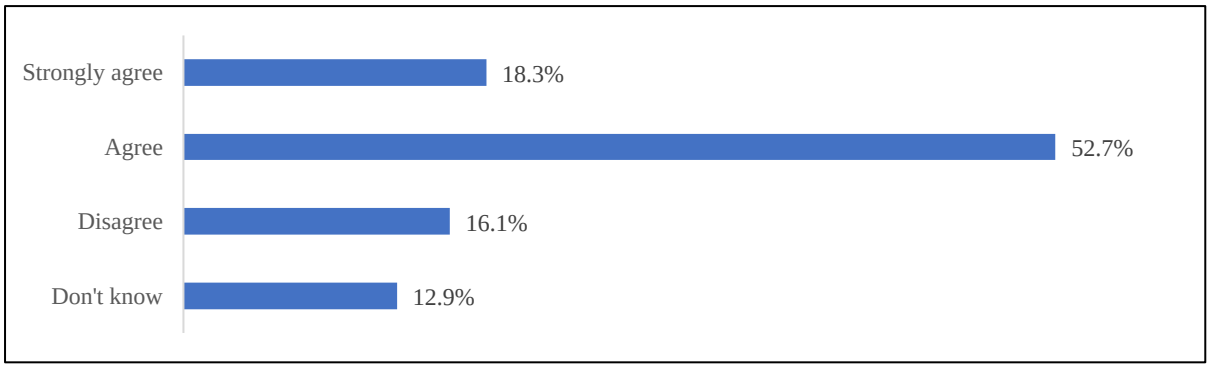
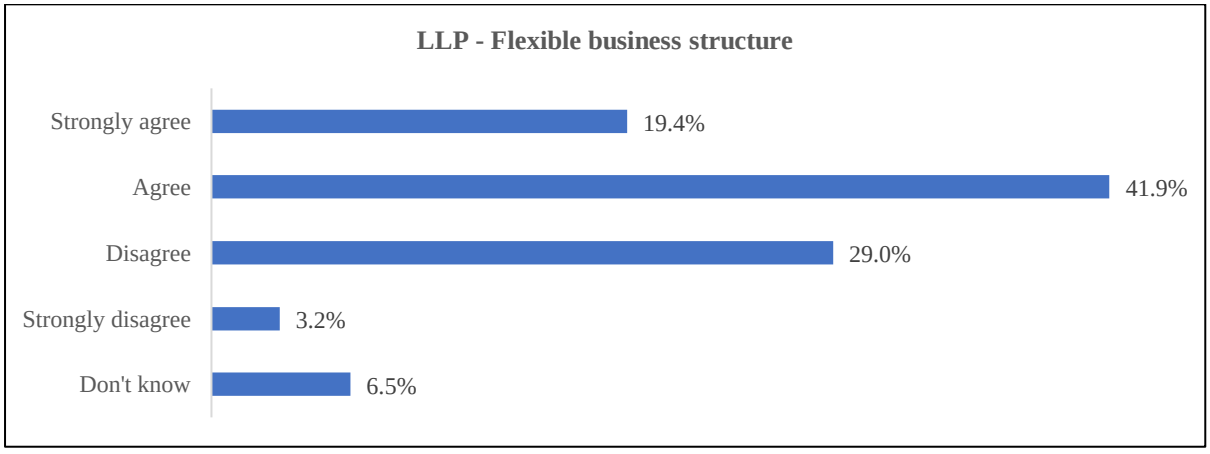


Figure 111: Agreement that flexible business structure is an advantage of the LLP (v2)



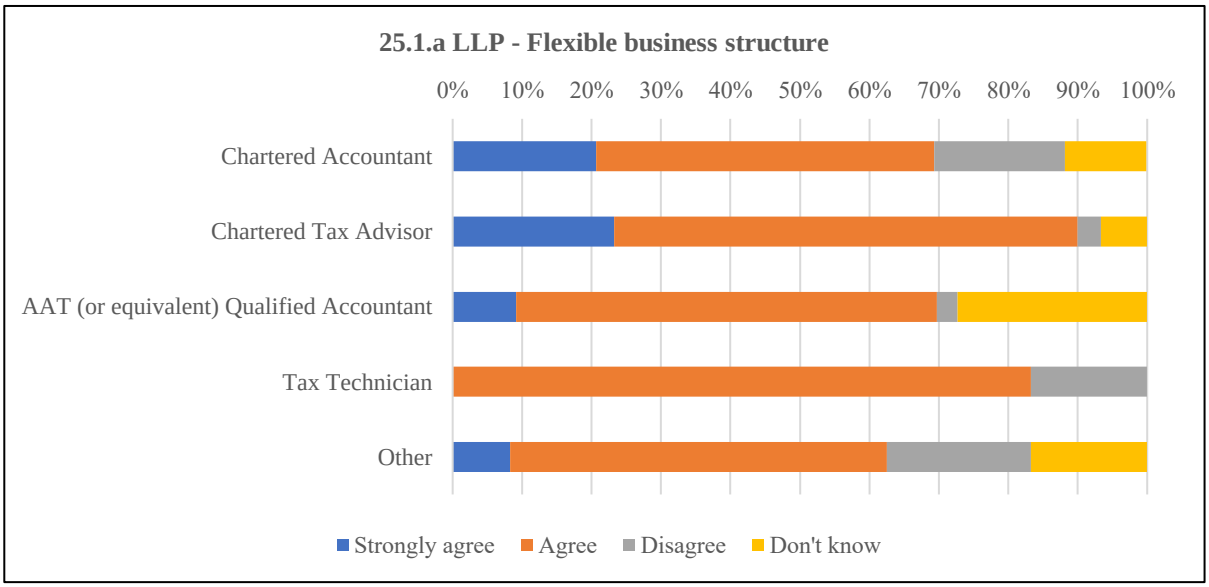
564 41/317.

565 225/317.

566 19/31.

Across the qualification groups, the Chartered Tax Advisors were most likely to agree with the proposition that flexibility is a merit of the LLP form; 90%,[567] as compared to the lowest 62.5%[568] in the 'Other' category (Figure 112). Once again, there is no overall trend here.

Figure 112: Agreement that flexible business structure is an advantage of the LLP, by reference to qualification



567 27/30.

568 15/24.

Figure 113: Agreement that flexible business structure is an advantage of the LLP, by reference to experience

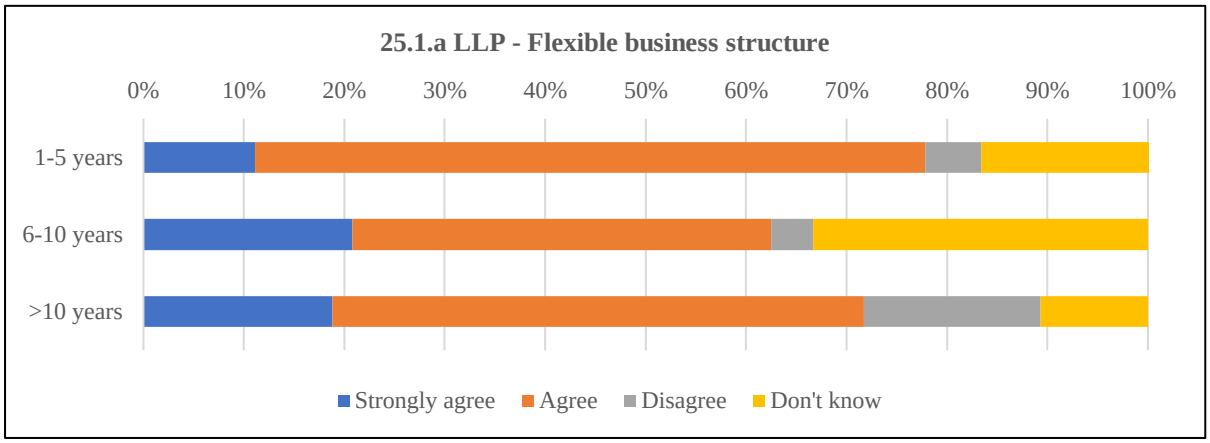
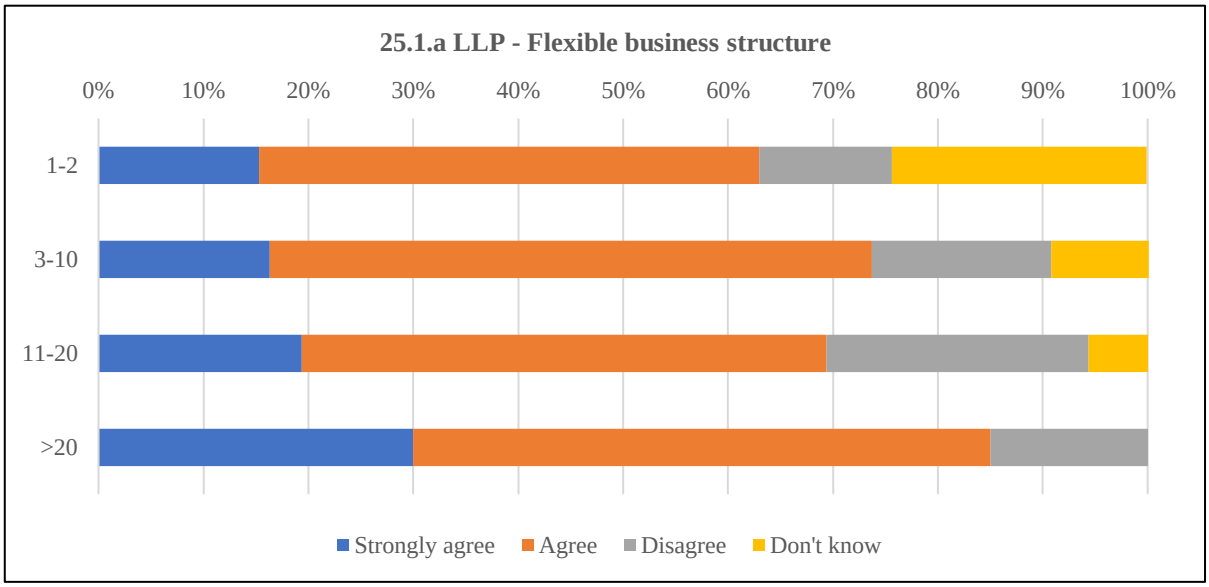


Figure 114: Agreement that flexible business structure is an advantage of the LLP, by reference to firm size



When the company related statistics are also considered (70.8% taking the view that the company was a flexible form), the end position appears to be that the three forms are perceived as having similar levels of flexibility, and on this metric all ought to be regarded as equally attractive to owner-managed businesses.

3.4.2.5 Degree of Personal Control

The flexibility of a partnership-type structure, at least in relation to the internal management of the LLP, naturally vests a higher degree of personal control in the hands of the LLP members than is the case with the company form. As outlined above, the LLP structure is more tightly regulated than the ordinary partnership in that it is not completely free from the oversight of the Companies House, but it is not restricted by the management provisions of the CA 2006, meaning that the LLP members arguably retain greater personal control than company owner-managers over important matters such as the alteration of profit-sharing arrangements,[569] the removal of capital, the decision-making process, and the way in which LLP members are appointed and removed. The survey results are consistent with the hypothesis that the LLP offers owner-managers a good degree of personal control over the management of the business, with 66%[570] of respondents agreeing that this was an advantage of the form, though this is lower than the 77.6% figure associated with the ordinary partnership, reflecting the additional regulation of the LLP. This ranked fifth highest on the list of prompted advantages,[571] though in the follow-up survey only 45.2%[572] respondents agreed that this was an advantage. Due to the initial mistake, and the inconsistency in the subsequent survey results, the gathered data on this point ought to be regarded as inconclusive.

569 OTS Disincorporation Relief (n 200) 13.

570 208/315.

571 Also true of the follow-up survey.

572 14/31.

Figure 115: Agreement that degree of personal control is an advantage of the LLP

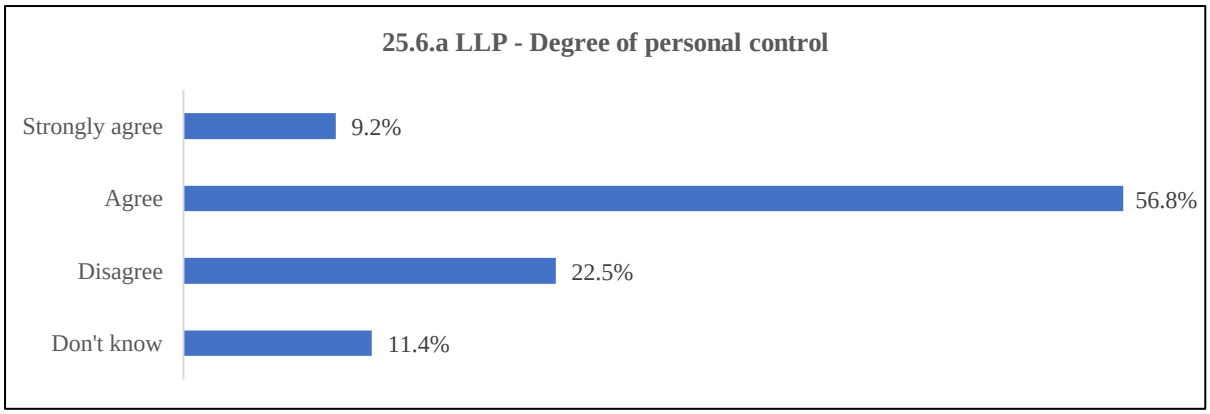


Figure 116: Agreement that degree of personal control is an advantage of the LLP (v 2)

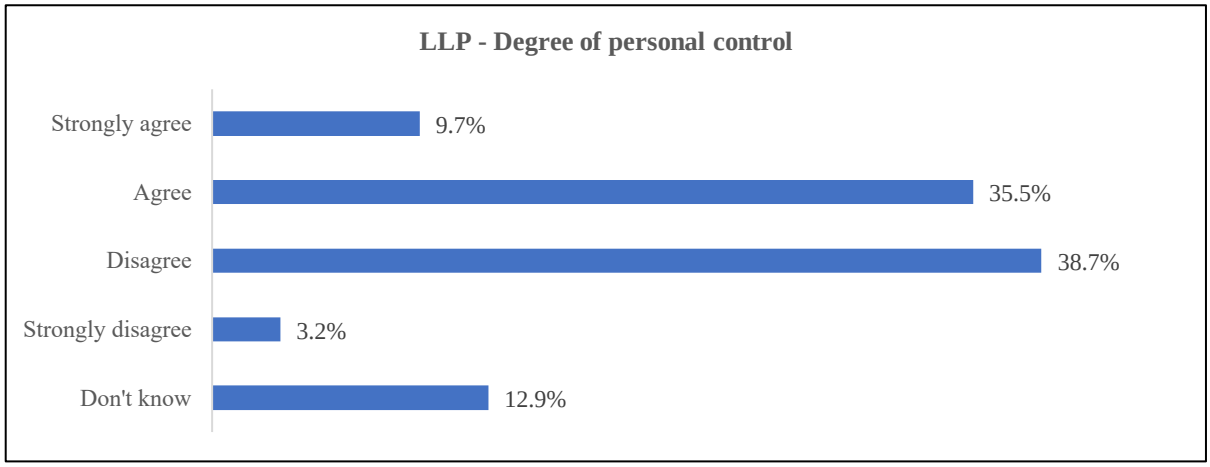
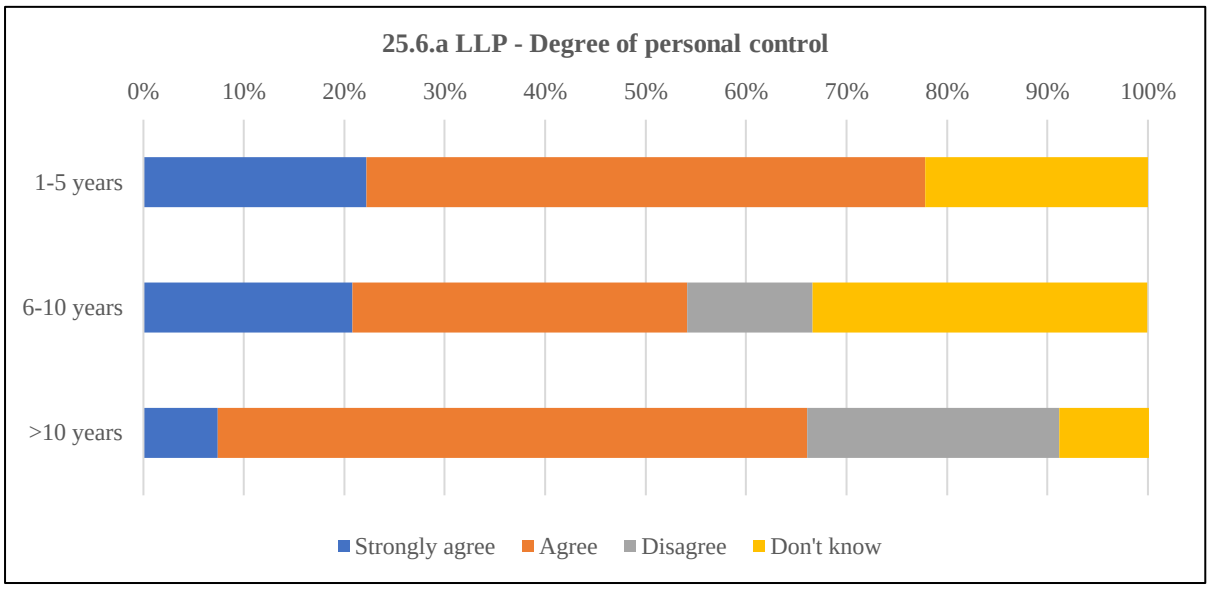


Figure 117: Agreement that degree of personal control is an advantage of the LLP, by reference to experience[573]



3.4.2.6 Privacy

The one advantage the LLP has over the company in privacy terms is that the members' agreement is not a document of public record. However, the details of at least two 'designated members', must be provided to the Companies House, which will be publicly accessible, in addition to any persons deemed to have 'significant control', which is highly likely to be all of the members of an owner-managed LLP.[574] Furthermore, 'in so far as accounts are concerned, the general approach is that the rules in the Companies Acts on accounts and auditors are made applicable with some appropriate modifications. The formation of the LLP may therefore result in some loss of privacy [as compared to a partnership].'[575] When asked whether privacy was

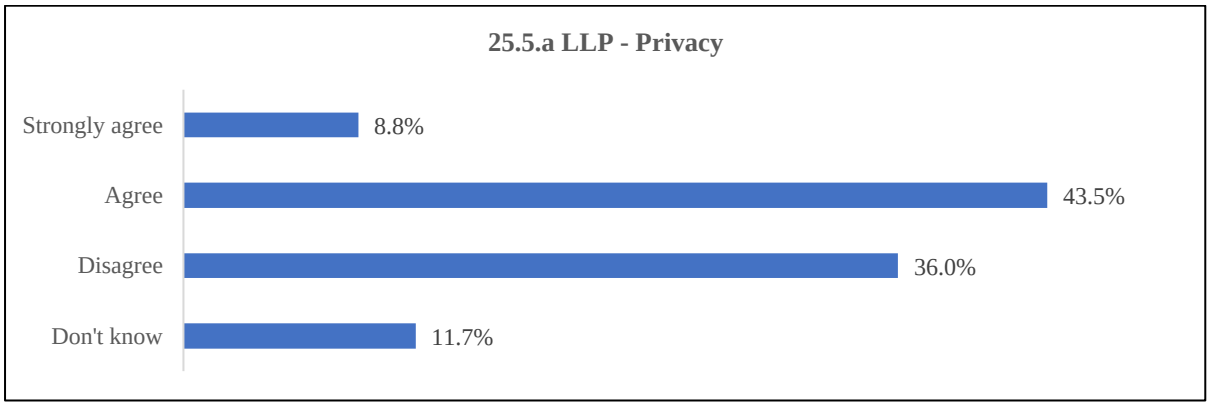
573 Cross-tabulated data has not been presented for qualification and firm size since the overall difference in viewpoint amongst the categories was less than 5%.

574 LLP Act 2000, s 2.

575 Palmer's (n 56) 1.208.

an advantage of the LLP for owner-manged businesses, only a small 52.3%[576] majority agreed that this was so. This is 27.1% less than the number of respondents reporting that privacy was an advantage of the ordinary partnership and consistent with the losses just highlighted. In the follow-up survey, the position was one of disagreement (51.6%)[577] with the proposition that privacy is an advantage of the LLP form (Figure 119).

Figure 118: Agreement that privacy is an advantage of the LLP



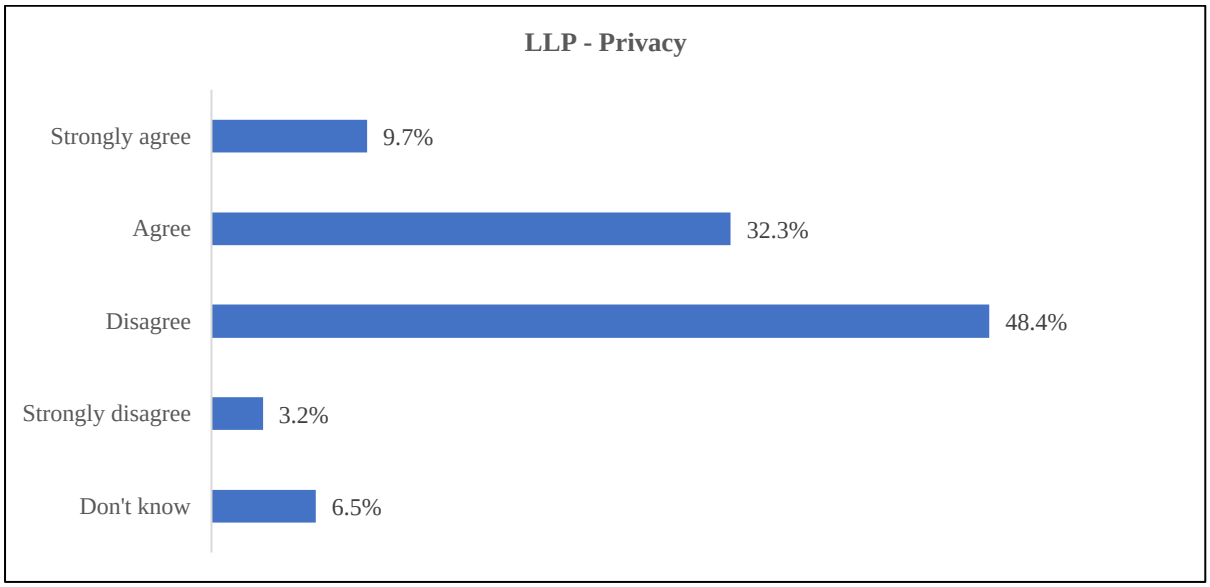
There is little doubt that in terms of reporting and accounting requirements the LLP offers little, if any, advantage over the limited company. Rowlands and Zeider (n 434) 36.23: 'The accounting disclosure requirements and audit provisions of the CA 2006 (which replaced the CA 1985 rules with effect from October 2008) apply to an LLP and, accordingly, all the relevant FRSs, SSAPs, SORPs, IASs (if adopted), the requirement that the accounts give a 'true and fair view', etc, will apply. The principal exemptions to the company accounts rules are those relating to shares, to the preservation of capital and to distributions…the principal advantage of limited liability has an obvious appeal to partners who wish to protect their personal assets from suits against their businesses, but the cost on terms of lost financial privacy is too heavy for some to bear.'

Freedman JCL (n 98) 915: '[t]he case for the LLP as an ideal package for small trading businesses is not made out. External relations rules offer no simplification and no reduction in red tape as compared to companies.'

576 166/317.

577 16/31.

Figure 119: Agreement that privacy is an advantage of the LLP (v2)



A significantly greater proportion of Tax Technicians than respondents in other qualification groups agreed that the LLP is beneficial in terms of privacy (83.3%[578] agreed). Ordinarily, the Tax Technician category would be treated with caution on the basis of low response figures, but it can be observed that the similarly qualified AAT (or equivalent) respondents registered the second highest agreement response rate (57.6%),[579] thus indicating that the least qualified were, broadly, most positive on this point.

578 5/6.

579 19/33.

Figure 120: Agreement that privacy is an advantage of the LLP, by reference to qualification

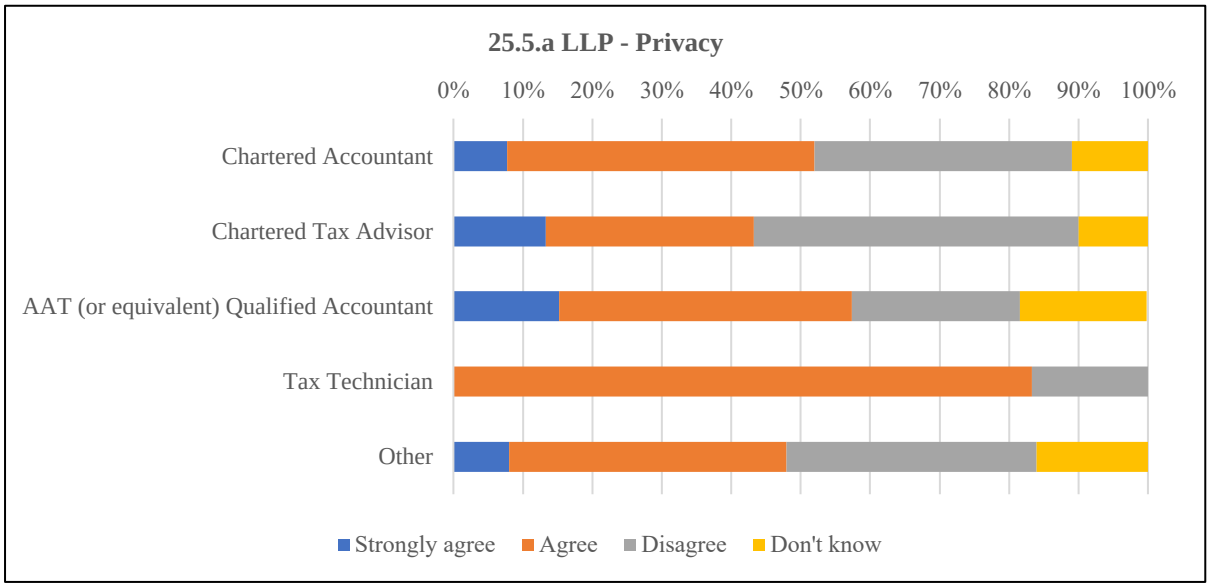
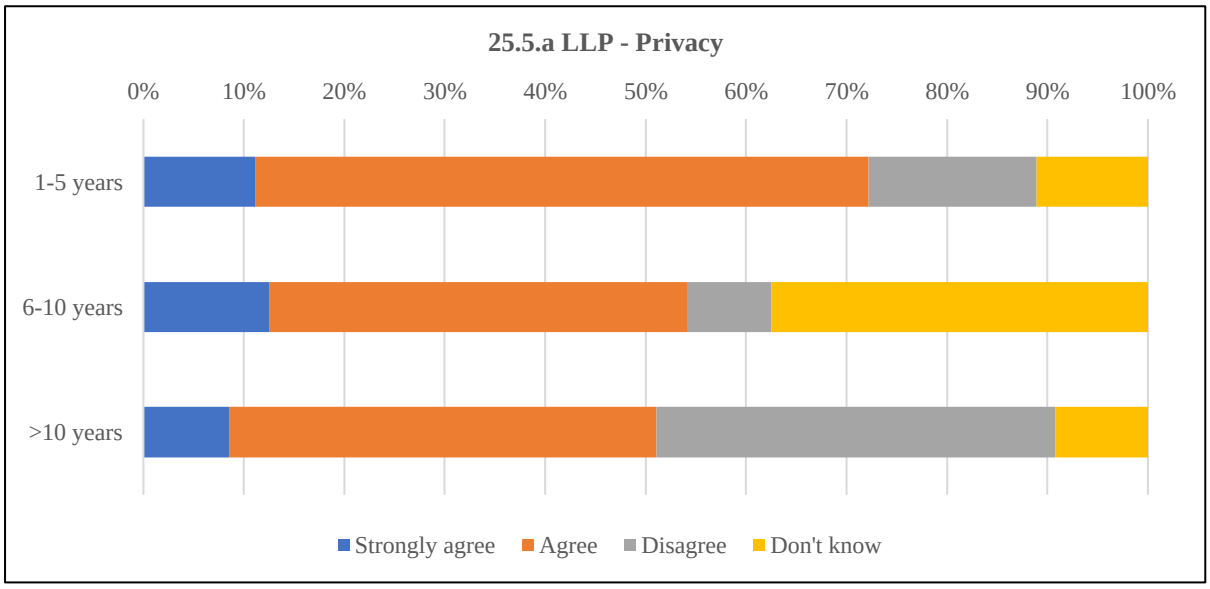


Figure 121: Agreement that privacy is an advantage of the LLP, by reference to experience[580]



It is also worth recalling that 52.5% of respondents disagreed with the proposition that the company lacked privacy. It therefore seems to be that the company and the LLP are on a

580 Cross-tabulated data has not been presented for firm size since the overall difference in viewpoint amongst the categories was less than 5%.

level playing field in this respect; perhaps the benefits of having a private LLP agreement are more apparent than real.

3.4.3 Interim Position

The data thus far suggests that the LLP should be regarded as a serious option for owner-managed businesses; this proposition extends to the professional and non-professional sectors alike as all are able to benefit from numerous advantages of the form which, according to the author's survey include:

- Limited liability;
- Separate and continuing legal personality;
- Ease of partner movement (in and out);
- Flexible business structure;
- Degree of personal control;*
- Privacy.*[581]

Indeed, one survey respondent said, '*I would normally recommend an LLP – simple, straightforward and practical.*' The draw of limited liability and separate legal personality are in play, seemingly remedying two key perceived deficiencies in the ordinary partnership structure for owner-managed businesses. The price to pay appears to be a marginal loss of personal control, and a loss of privacy, but the inherent flexibility of the partnership is preserved in the LLP form, which can facilitate smoother management of the firm and its assets.

581 *Depending on which survey is taken as a guide.

Ostensibly this 'price' is, at least slightly, less than that associated with incorporation as a limited company, which is subject to greater state control and regulation.

If limited liability is desired by owner-managed businesses then in instances where there is no separation of ownership and control, as is often the case, the LLP seemingly offers a better framework than the company. Finch and Freedman acknowledge that until a split in ownership and management occurs 'its [the LLPs] internal governance may be more flexible and better reflect the fact that ownership and management are not split than does the corporate form'.[582] It does so because so long as the separate legal personality of the LLP is appropriately acknowledged, the owners do not need any detailed understanding of a legal entity distinct from the ownership of the business.[583] In addition, whilst partnership law has never imposed a blanket ban on partners from simultaneously being employees, it is regarded as a long-established principle by the courts that a 'true partner' (typically an equity partner who takes part in the management, contributed capital and shares in the profits) will not be regarded as an employee.[584] Section 4(4) LLP Act 2000 provides that 'a member of a limited liability partnership shall not be regarded for any purpose as employed by the limited liability partnership unless, if he and the other members were partners in a partnership, he would be regarded for that purpose as employed by the partnership' and therefore applies the partnership principles to the LLP.[585] The combination of these factors means that if members happen to

582 Finch and Freedman (n 354) 501.

583 OTS Disincorporation Relief Report (n 200) 13.

584 Blackett-Ord and Haren (n 441) 714-716; Berry (n 446) 214. Cf: Jeremias Prassl, 'Members, Partners, Employees, Workers? Partnership Law and Employment Status Revisited' (2014) ILJ 495, 501, 502; David Milman, 'A Review of Developments in Partnership Law 2017' (2017) Co LN 1. In *Reinhard v Ondraw LLP* [2015] EWHC 26 (Ch) and [2015] EWHC 1869 (Ch) Warren J decided that it is not possible for an individual to be both an LLP member and an employee, though see footnote immediately below.

585 *Clyde & Co v Bates van Winkelhof* [2014] UKSC 32 confirms that a member may be a 'worker' for the purposes of Employment Rights Act 1996 ("**ERA 1996**"), s 230(3)(b). This may result in differential treatment as between the ordinary partnership and LLP: see Berry (n 446).

mix their personal and business assets, whilst it is not desirable to do so, it will not generate any charges linked with section 455 CTA 2010; and, only in the very rare case, would it generate any charges on the basis that there is an employee-related benefit. Thus, the 'trap for the unwary' associated with the company form is successfully navigated by owner-managed businesses that choose to operate through an LLP.[586]

The LLP Report also explored the levels of dissatisfaction with the LLP form. Only 2 out of 172 (1.2%) SME respondents indicated dissatisfaction with the LLP on the basis that they thought it was an unsuitable business form for SMEs.[587] Even if one assumes that both of the negative responses were provided by the 'very small' LLPs (those with less than £100,000 turnover),[588] this amounts to a dissatisfaction rate of just 4%. Mishcon De Reya are also reported as saying that 'small organisations operating in a range of industries may be able to benefit from operating as an LLP and those that had an existing LLP structure reported reaping significant rewards as a result'. [589] Overall, it appears that those who have tested the LLP form have been generally positive about their experience. However, by this stage, it is also apparent

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586 Salaried partners must be careful not to trigger the application of ITTOIA 2005, ss 863A-G (Finance Act 2014, Sch 17) which would render the member an employee for tax purposes. So long as the individual concerned is a genuine owner-manager i.e. has significant influence on the running of the business, then condition B of the provisions will not be satisfied, and they will continue to be treated as self-employed for tax purposes. These anti avoidance rules have been linked to the stagnation and fall in the number of LLPs in recent years: Michael Beart and Francis Fitzpatrick QC, 'When is a Partner an Employee?' *Tax Adviser,* 1 November 2019.

587 3,500 LLPs were invited to complete the questionnaire, but only 195 responded (5.57% response rate): LLP Report (n 36) 24. A larger response rate would have provided greater strength to the conclusions and arguments made herein, though the authors considered that the turnout was enough to provide a reliable source of information.

588 Amounting to 51 (26.1%) of the respondents. This is doubtful since page 41 of the LLP Report (n 36) also indicates that none of the 'very small' firms expressed dissatisfaction on the basis the 'complicated structure' of the LLP.

589 James Hurley, 'Small businesses "overlooking" LLP Structure', *The Telegraph,* 11 April 2011 <https://www.telegraph.co.uk/finance/businessclub/8443367/Small-businesses-overlooking-LLP-structure.html> accessed 3 April 2022.

that the LLP is not widely used by owner-managed businesses, notwithstanding the touted attraction. Accordingly, it falls to be considered whether there are other reasons, not yet explored, that can account for the why the LLP has been abandoned by owner-managers and their advisors. Part 3.4.4 (below) is dedicated to these points.

3.4.4 LLP Disadvantages

Academic literature has highlighted the complexity of the LLP structure, resulting from the infusion of company and partnership law, as being the primary drawback of the form. Freedman notes:

> [t]he…problem with LLPs is that the method used – of adopting company law by reference to modifications in Regulations – has resulted in great complexity, and a set of provisions which are very difficult to use, even for seasoned professionals…These provisions will be even more difficult to use than the Companies Acts for small businesses, since the reader needs to have open before him the Companies Acts, the LLP Act, and the Regulations, and to cross refer continually…Not only does the reader have to juggle with the books, he also needs a knowledge of both company law and partnership law.[590]

If the level of complexity is such that owner-managed businesses, and their advisers, find the LLP difficult to create and manage, then the company might properly be regarded as the only viable business form for small businesses seeking limited liability. Some academic commentary is more positive about the operative LLP provisions. In 2009, Sir Michael Briggs commented:

> a feature of the arrival and success of the LLP [as being] is that it has yet to give rise to any serious or expensive litigation about how it works…[and] that users

[590] Freedman (n 98) 903. See also Finch and Freedman (n 354) 501.

> of LLP's and those who deal with them have yet to get bogged down in any real legal controversy about them.[591]

Similarly, in 2013, whilst conducting a review of recent cases in partnership law, Milman commented:[592] '[o]ne might have anticipated a burst of litigation on a range of novel aspects in the law relating to limited liability partnerships (LLPs), but the irony is that much of the litigation…features the interpretation… of the Partnership Act 1890.' More recently, when considering the complexity concerns involved in creating a new limited liability form for sole traders, the OTS observed that 'the considerably more complex LLP has been well absorbed'.[593] Furthermore:

> [a]lthough the expectation was that the main users would be large accounting firms (who faced significant threats of lawsuits), in fact the LLP has been widely adopted by accountants, lawyers, tax advisers, surveyors, architects and many other professional businesses of all sizes [including two-partner businesses]. The vehicle allows the firm to retain the partnership ethos whilst guarding against 'catastrophe' claims.[594]

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591 Jeremy Callman, Gavin Foggo and Molly Ahmed, 'The Application of the Default Provisions in the Limited Liability Partnership Regulations 2001', June 8 2011 <https://www.foxwilliams.com/news/216/> accessed 3 April 2022. Whilst newly reported cases are becoming more common, the main difficulties appear to arise from the factual complexity of the cases concerned: see David Milman, 'Partnership Law: An Overview in 2013' (2013) Co LN 1. The biggest controversy has been in relation to the applicability of ERA 1996, s 230(3)(b) which offers protection to worker/employee whistle blowers. In *Clyde & Co v Bates van Winkelhof* [2014] UKSC 32 the Supreme Court considered than an LLP member may be a 'worker' and therefore protected. Two outstanding issues appear to be the applicability of the doctrine of repudiatory breach to two-member LLPs: the issue was left open in *Liontrust Investment Partners LLP and others v Flanagan* [2017] EWCA Civ 985 (affirming [2015] EWHC 2171 (Ch)) and whether or not members owe fiduciary duties as between themselves (as opposed to just the LLP).

592 Milman (n 591) 1.

593 OTS SEPA Final Report (n 36) 8, 16.

594 OTS Partnerships Interim Report (n 33) 25, 76.

The problem with the observations by the OTS is that they do not, at least explicitly, address the role of the LLP for non-professional businesses. Professional businesses might be regarded as better placed to deal with more complex legal structures, especially when one considers that a significant number of LLPs are accountancy and legal firms, or special purpose vehicles that are likely supported by professional advice. Finch and Freedman argue that the LLP is a particularly inappropriate business structure for owner-managed, non-professional businesses.[595] These types of business might be regarded as less well equipped to deal with the complexity involved in the creation and operation of the LLP.

In light of the above, the author's survey explored disadvantages that might be regarded as linked with the apparent complexity of the form. The following options were given:

- Costly administrative/compliance burdens;
- Expensive and complicated to set up;
- Lack of knowledge/information about LLPs;
- Lack of prestige/credibility;
- Tax treatment.[596]

An 'other' category was also available, which invited respondents to note further disadvantages associated with the form.[597] Two respondents alluded to general complexity as

595 Freedman (n 98) 898; Finch and Freedman (n 354) 475.

596 See Chapter 4.

597 12 responses in total were received, many of which expressed general opinions on the LLP, rather than being specific in relation to disadvantages. Two referred to the issue that LLPs have been/are perceived to be used for fraudulent purposes, thereby leading to a cultural suspicion of LLPs.

being an issue for owner managed businesses, and another canvassed the opinion that the LLP was '*the worst of both worlds, at least for the smallest businesses*.'

3.4.4.1 Administrative and Compliance Burdens

The majority of the LLP administrative/compliance burdens stem from the duty to report to the Companies House; accounts and confirmation statements must be filed on an annual basis, LLP statutory registers must be maintained (detailing LLP members, their usual addresses, and a register of people with significant control)[598] and any changes to the LLP details must be sent to the Companies House. As with the company, such is the price to pay for limited liability. Indeed, McCahery, Vermeulen and Priydershini have observed that '[w]hilst the UK-LLP extends limited liability to all types of firms, the effect of high transaction costs will arguably limit its suitability for most SMEs.'[599] Unfortunately, owner-managers opting for the LLP form cannot take advantage of the Company Accounts Tax Online service which enables companies to file the same accounts for Companies House and HMRC purposes under a unified system (though it should also be noted that agents cannot use this service either e.g. accountants acting on behalf of owner-managed companies).[600] However, there are potential administrative cost savings when compared with the company. Given the basic position that members are not employees, owner-managers need not even begin to concern themselves with PAYE, potential employment law issues,[601] national minimum wage requirements, and auto-enrolment for

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598 In the case of owner-managed businesses any such registers will be short and simple, but nonetheless need to be maintained.

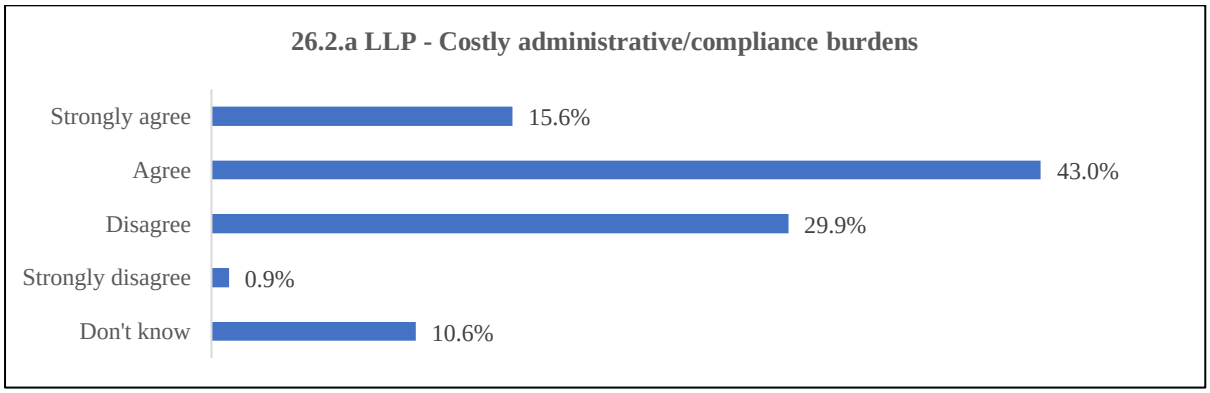
599 McCahery, Vermeulen and Priydershini (n 354) 315.

600 For further information see: HM Revenue and Customers, *Check if you can use the HMRC Corporation Tax online filing service* <https://www.gov.uk/guidance/corporation-tax-use-hmrcs-free-filing-software> accessed 3 April 2022.

601 Subject to the 'worker' point at (n 591) above. This ought not to be of concern to the typical owner-managed business.

pensions (where relevant). Nonetheless, 58.6%[602] of the survey respondents agreed that the LLP administrative and compliance burdens were a disadvantage of the form, which is 7.3% higher than the figure recorded in relation to company administrative and compliance burdens, thereby suggesting that the aforementioned 'savings' might not be accessible in practice (or that familiarity with the company burdens means that they are perceived as being less problematic).

Figure 122: Agreement that costly administrative/compliance burdens are a disadvantage of the LLP

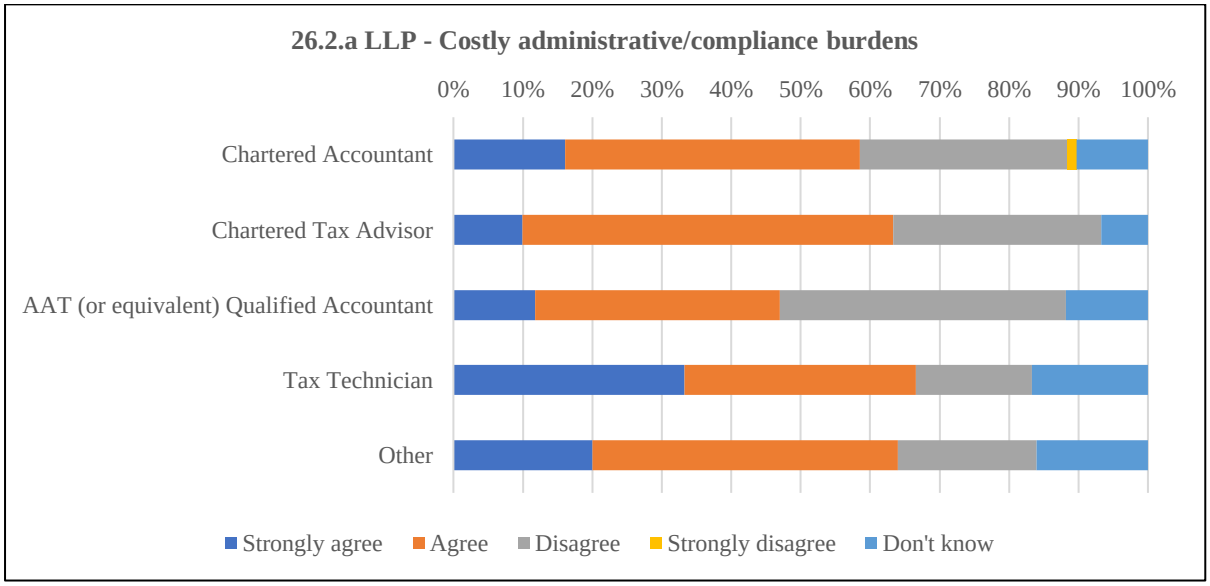


Cross-tabulation of the data against qualification evidences that the levels of agreement across the majority of qualification groups are within a reasonably close 5.2% margin, bar the AAT (or equivalent) qualified accountants, out of whom only 47%[603] agreed that the LLP has costly administrative and compliance burdens (Figure 123).

602 188/321.

603 16/34.

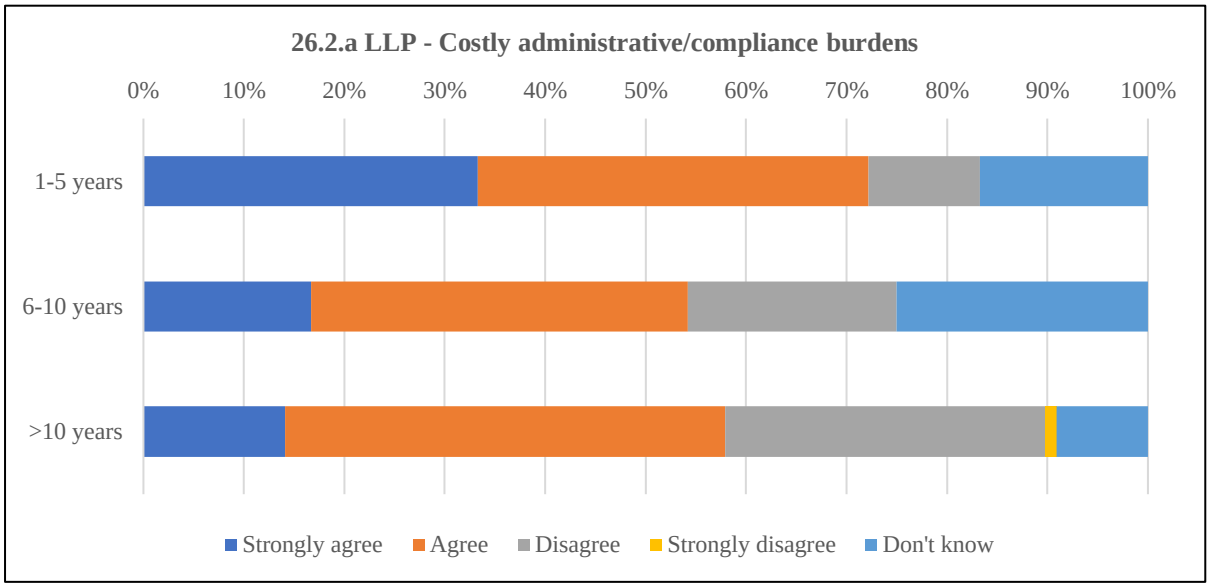
Figure 123: Agreement that costly administrative/compliance burdens are a disadvantage of the LLP, by reference to qualification



Interestingly, notwithstanding the fact that respondents in the 1-5 years' experience group were generally more inclined to agree that the prompted advantages were associated with the LLP form, they were also most likely to agree that the LLP has costly administrative and compliance burdens (72.2% agreed;[604] 18% more than respondents with 6-10 years' experience) (Figure 124).

[604] 13/18. Note also the low level of disagreement – 11.1% (2/18).

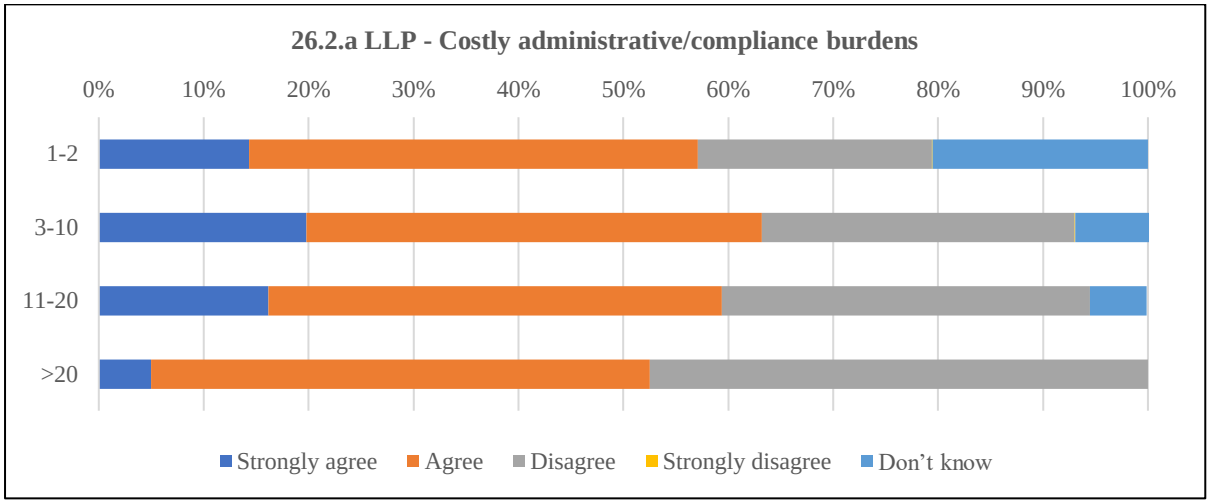
Figure 124: Agreement that costly administrative/compliance burdens are a disadvantage of the LLP, by reference to experience



If the data is cross-tabulated by reference to firm size, it is clear that as firm size increases, the more likely the respondent was to disagree with the proposal that the LLP has costly administrative and compliance burdens – the largest figure reaching 47.5%[605] in firms with more than 20 accountants (Figure 125). The number of 'don't know' responses also reduced as firm size increased, suggesting that larger firms are better acquainted with the LLP form than their smaller counterparts, though the level of agreement only varied by 10% across all firm sizes.

605 19/40.

Figure 125: Agreement that costly administrative/compliance burdens are a disadvantage of the LLP, by reference to firm size



Crucially, the survey responses indicate that the LLP is perceived to be the most problematic business form when administrative and compliance burdens are considered. This ranked third in the list of prompted disadvantages.

3.4.4.2 Expensive and Complicated to Set Up

The process of LLP incorporation is governed by sections 2, 3 and Schedule 1 LLP Act 2000, and broadly replicates that pertaining to the company,[606] though it is currently not possible to utilise the Companies House web formation service for the registration of LLPs.[607] In 2001, Freedman[608] argued that because the LLP lacks rules on internal governance, it would be more

606 Note that an LLP cannot be formed otherwise than for 'carrying on a lawful business *with a view to a profit*'. For more detailed information on the incorporation process see Morse (n 12) Chapter 10.

607 At the time of writing, the paper application fee is £40, which is the same for companies. However, the Companies House web formation service for companies costs just £12 for the initial set up. Information obtained from <https://www.gov.uk/government/publications/companies-house-fees/companies-house-fees> accessed 3 April 2022.

608 Freedman JCL (n 98) 902.

expensive (than a company) to set up for owner-managed businesses. Lindley and Banks note that there is an ironic 'assumption that it is a possible to draft a comprehensive agreement which covers all possible eventualities [that] underpins the [LLP Act] 2000,' which is certainly not present in ordinary partnership law. That being the case, there is a distinct lack of 'default' rules for the LLP[609] within the LLP Act 2000; members cannot fall back on the PA 1890 nor the model articles of association for private companies limited by shares[610] (which are often adopted by simply ticking a box[611] on the Companies House incorporation form).

Building upon previous work, and writing in 2002, Finch and Freedman[612] noted that the cost of setting up an LLP through Jordans LLP was £488.75 compared to just £145 for setting up a company. By 2018, the cost for both of these services had reduced and the Jordans LLP standard service for setting up a company was quoted at £119 (a 17.9% decrease) and £145 for setting up an LLP (a 64.4% decrease).[613] Whilst the LLP was still more expensive, the significant decrease in price suggests that professional business advisors (or at least this firm) have worked towards developing a more standardised approach to both the incorporation of the LLP and drafting of LLP agreements:

> … corporate lawyers have already taken steps to avoid the most costly aspects of the Act by experimenting with key provisions within the LLP agreement for the benefit of the mixture of large and smaller firms contracting into this form. The result is that the UK-LLP has become a practical and useful vehicle for a variety of small and larger businesses…[614]

609 Though LLP Regulations 2001, SI 2001/1090, Pt VI declares some default rules prescribing the mutual rights of the members of the LLP that bite when an agreement has not been reached.

610 Companies (Model Articles) Regulations 2008, SI 2008/3229.

611 Box A8 Form IN01, Application to Register a Company.

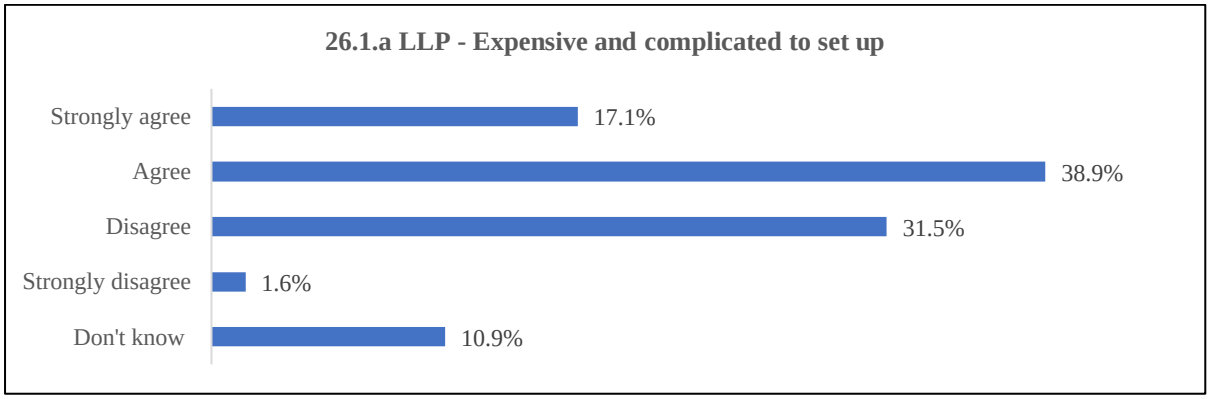
612 Finch and Freedman (n 354) 477.

613 Prices quoted are plus VAT. These are the last publicly available figures, as Jordans LLP was acquired and rebranded as Vistra in April 2019. Prices are no longer publicly advertised.

614 McCahery, Vermeulen and Priydershini (n 354) 336.

The cost and complexity elements were also addressed in the author's survey. A total of 56%[615] agreed that the LLP is expensive and complicated to set up, suggesting that the accounting profession still encounters difficulties in the LLP incorporation process. This ranked fourth in the list of prompted disadvantages.

Figure 126: Agreement that the LLP is expensive and complicated to set up[616]



Overall, albeit by a relatively fine margin, the respondents from the largest firms (more than 20 accountants) actually disagreed with the proposition that the LLP is expensive and complicated to set up (52.5%)[617] (Figure 127). Furthermore, none of the respondents in this category selected the 'don't know' option provided.[618] It may well be that the largest accountancy firms have made the advances of the kind outlined by McCahery, Vermeulen and

615 180/321.

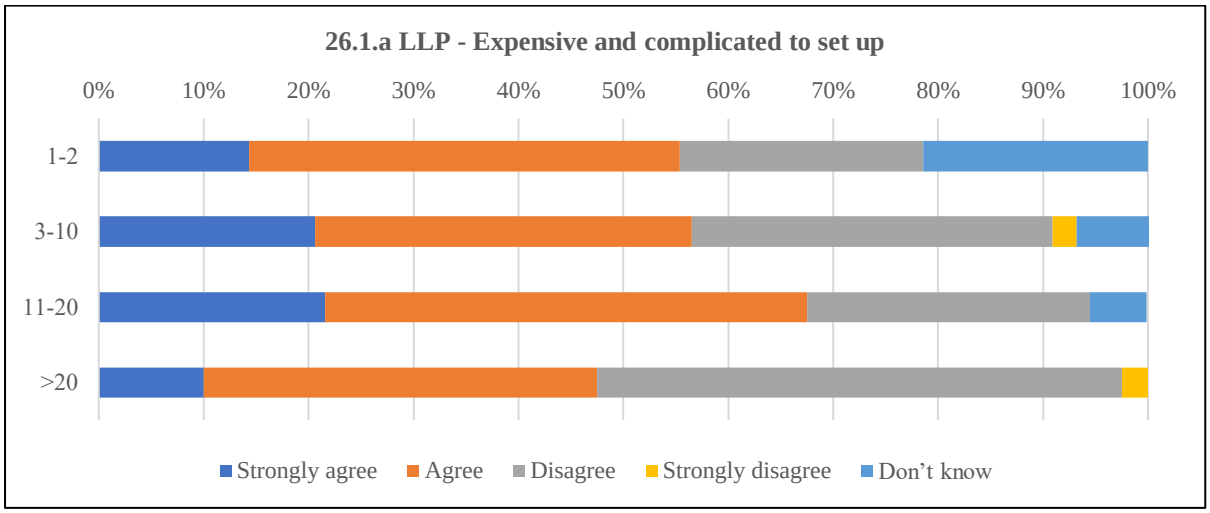
616 Cross-tabulated data for qualification and experience has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

617 21/40.

618 This is consistent with the position on administrative and compliance burdens. It is also worth noting that, as with the previous question, the highest proportion of 'don't know' (21.4%) responses came from the smallest firms (1-2 accountants).

Priydershini[619] above, though these developments do not yet appear to have 'trickled-down' to smaller firms.

Figure 127: Agreement that the LLP is expensive and complicated to set up, by reference to firm size



The respondents who had previously advised an owner-managed business to form an LLP were also asked to indicate whether they had formed an LLP for such clients. 70.1%[620] had done so, which is significantly higher than the number of accountants that had both advised an ordinary partnership and drafted a partnership agreement (18.4%).[621] It is possible that the higher LLP figure is attributable to accountants effecting the Companies House formation, thereby enabling a 'yes' response to the question and then outsourcing the drafting of the LLP agreement to a lawyer, or advising a client to seek the assistance of a lawyer for this task.[622]

619 (n 354).

620 96/137.

621 Of the 74.2% (262/353) respondents that had advised their owner-managed business clients to form an ordinary partnership. This is still significantly less than the 95.2% (336/353) who had formed a company for an owner-managed business client.

622 One response to question 29 (pertaining to difficulties encountered in LLP formation) noted that there was a lack of formation agents for LLP, another commented that there was cost and difficulty involved in establishing a partnership agreement with solicitors. One more positive response said that they simply

Based on the responses to questions in the partnerships section of the survey,[623] the outsourcing of drafting agreements appears to be the norm for ordinary partnerships and, as previously noted, the default provisions of the PA 1890 make operating as an ordinary partnership without an agreement in place feasible, even if not advisable. The fact that 67.4%[624] of the respondents answering this question who had not previously drafted a partnership agreement had nonetheless formed an LLP on behalf of an owner-managed business client, provides further evidence that outsourcing could be taking place. The alternative is simply that the majority of accountants who have taken to the time to familiarise themselves with the LLP form, have also taken additional steps to ensure that they are capable of drafting LLP agreements (or work for a firm that have developed standardised agreements), thereby enabling them to offer a comprehensive LLP service.

In any event, 84.6%[625] of the respondents who had previously drafted a partnership agreement on behalf of an owner-managed business client had also formed an LLP; a familiarity with drafting partnership agreements appears to increase the likelihood of an LLP having been formed on behalf of an owner-managed business client.

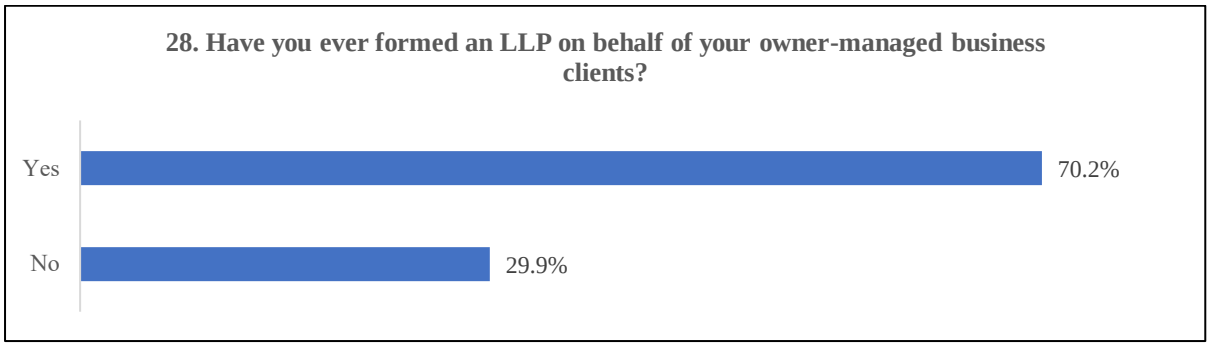
used an external incorporation service, the same as used for companies, for the LLP. These responses indicate that at least some degree of outsourcing is taking place.

623 Question 19, Figure 51.

624 62/92.

625 22/26.

Figure 128: Percentage of accountants that have formed an LLP on behalf of an owner-managed business



It is apparent that the respondents possessing higher level qualifications[626] were more likely to have formed an LLP on behalf of their owner-managed business clients. The highest percentage is associated with the Chartered Accountant qualification. 72.7%[627] had formed an LLP for an owner-managed business, whereas only 50%[628] of Tax Technicians and 57.1%[629] of AAT (or equivalent) qualified accountants had done so (Figure 129).

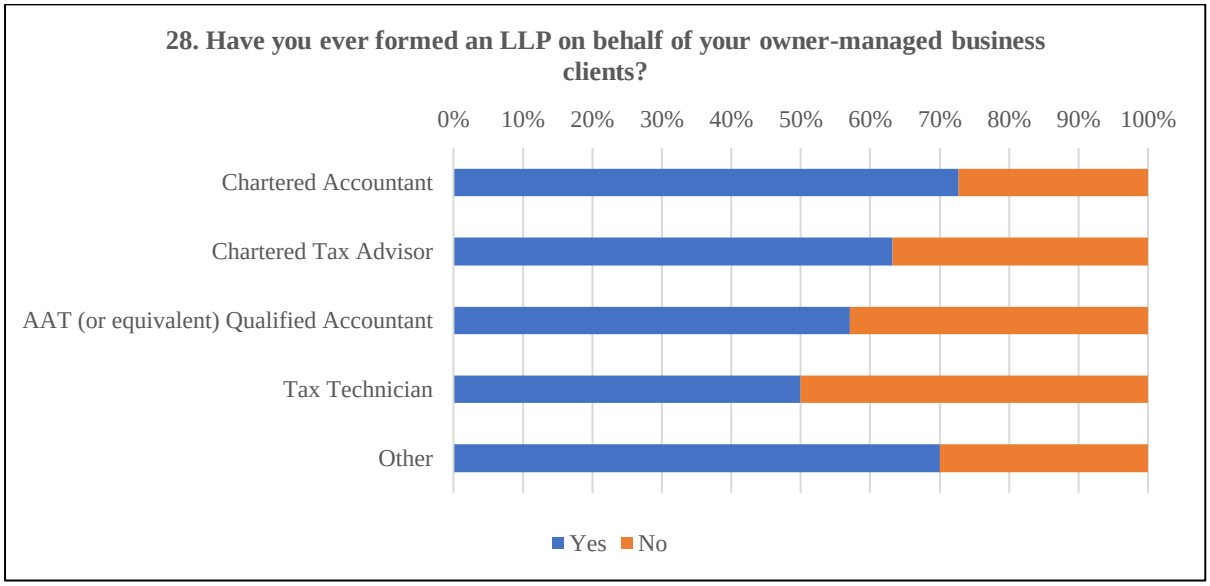
626 Chartered Accountant and Chartered Tax Advisor. Note that members of the 'Other' category include Chartered Management Accountants (also a higher-level qualification).

627 72/99.

628 1/2.

629 4/7.

Figure 129: Percentage of accountants that have formed an LLP on behalf of an owner-managed business, by reference to qualification

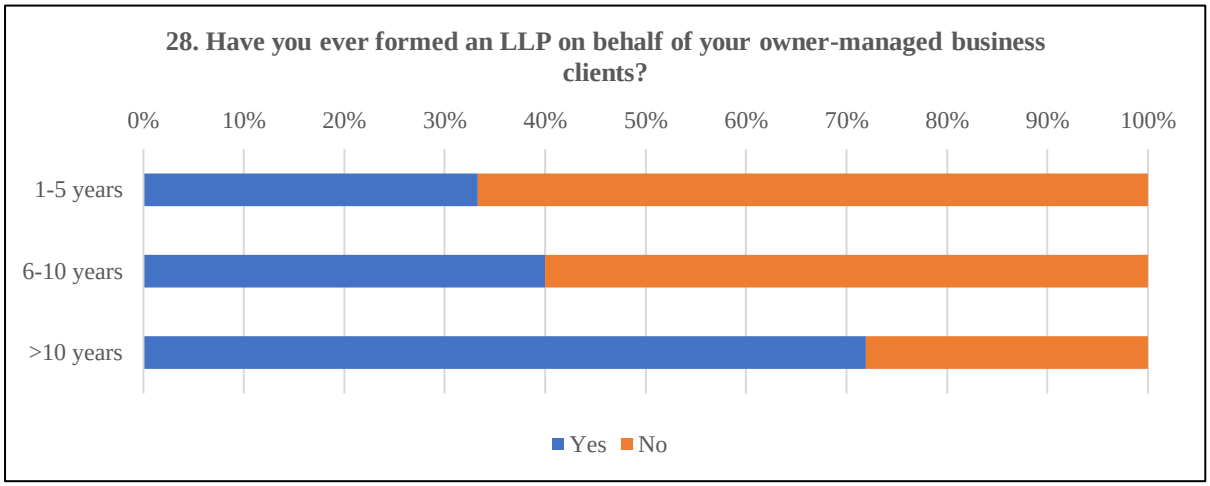


The cross-tabulated data also indicates that the likelihood of having formed an LLP on behalf of an owner-managed business increases in accordance with length of time in practice, just as it does in relation to the likelihood of advising owner-managed businesses to operate as an LLP. 71.9%[630] of the most experienced accountants (more than 10 years) had formed an LLP, compared with just 33.3%[631] of accountants in the 1-5 years category (Figure 130).

630 92/128.

631 1/3. A cautionary note is warranted in due to the low number of respondents presented with this question. In any event, the more than 10 years figure (71.9%) is also significantly higher than the 6-10 years category responses (40% had formed an LLP on behalf of an owner-managed business), but again there were only 5 responses to this question.

Figure 130: Percentage of accountants that have formed an LLP on behalf of an owner-managed business, by reference to experience



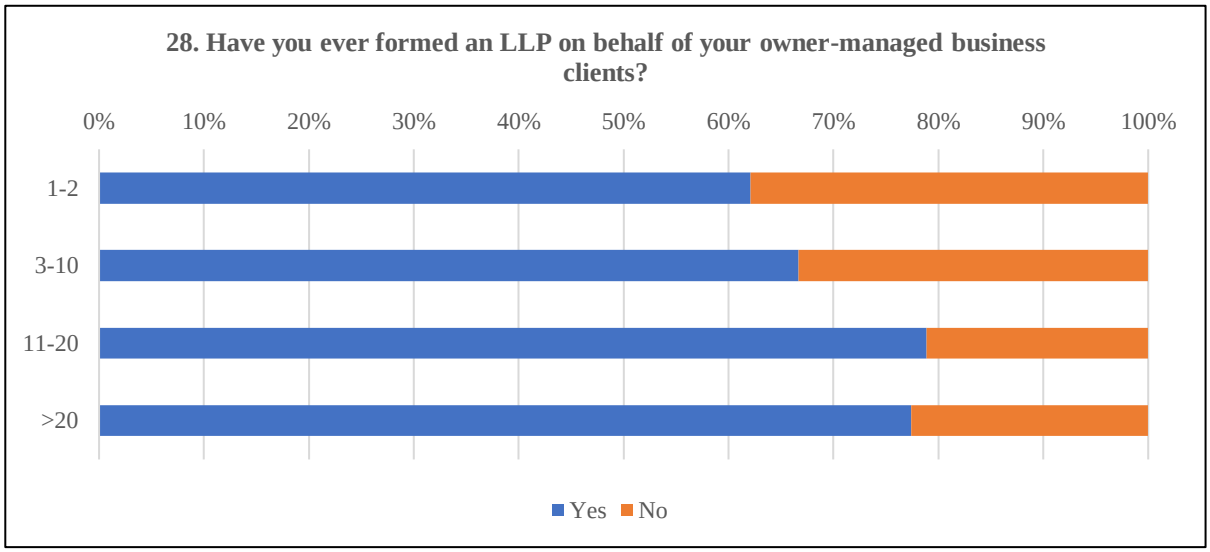
Bearing in mind the previous data, it is unsurprising that the accountants from larger firms were more likely to have assisted an owner-managed business with the formation of an LLP,[632] though in this case it was those with a firm size of 11-20 accountants that registered the highest percentage of 'yes' responses (78.9%,[633] as compared to firms with more than 20 accountants which returned a figure of 77.4%[634]) (Figure 131).

632 Note that, no trends based on size of firm were detected in the responses to Question 22 (have you ever drafted a partnership agreement on behalf of your owner-managed business clients?).

633 15/19.

634 24/31.

Figure 131: Percentage of accountants that have formed an LLP on behalf of an owner-managed business client, by reference to firm size



In addition to the LLP formation question,[635] the survey asked the respondents to indicate what, if any, difficulties were encountered as part of the formation process. 52 individuals provided responses, though not all pertained to the formation point.[636] 23 stated that they had not personally encountered any difficulties. However, 9 expressed concern with the need/ability to draft the LLP agreement (which feeds into cost), 5 indicated that the Companies House process of incorporation is more onerous (because of unavailability of online registration), and 3 noted that they had found it difficult to explain the LLP concept to owner-managers. Such problems no doubt make the LLP a less attractive business form.

In order to explore the cost point in more detail, the author's survey asked the accountants to indicate how much they would typically charge an owner-managed business to

635 Question 28, as detailed in the graphs and text immediately above.

636 Responses in this category included: complex accounting; partner disagreements; changes in the circumstances of the partners; liability exposure and, money laundering requirements.

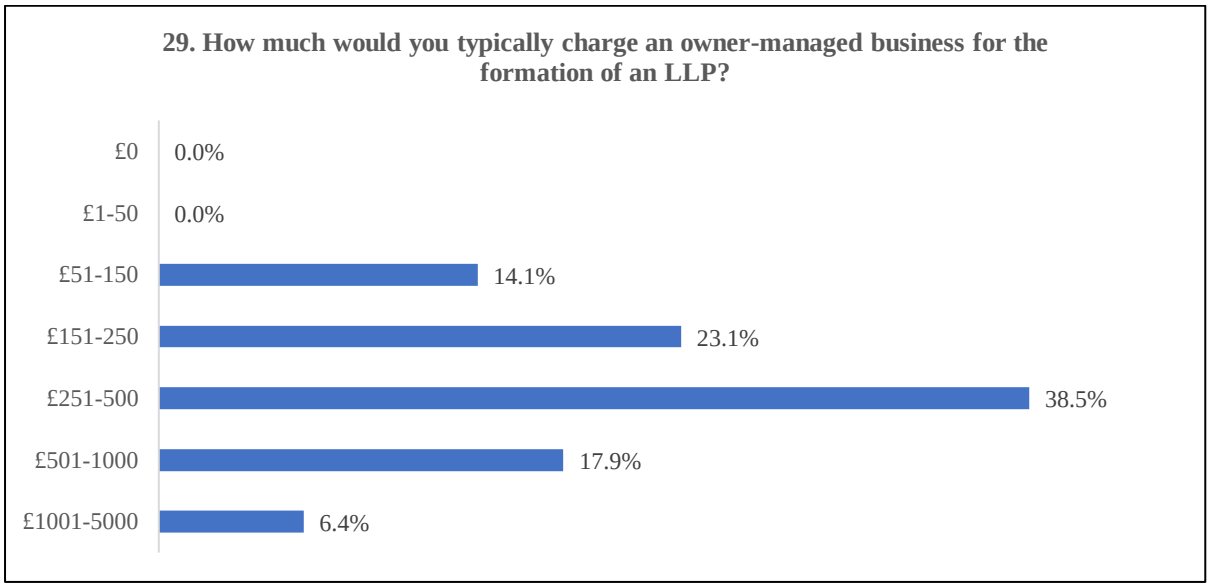
form an LLP.[637] The median price range for the LLP formation service was £250-500 (38.5%),[638] which is the same as that reported for the drafting of an ordinary partnership agreement. As was also the case with drafting an ordinary partnership agreement, no respondents were willing to offer the service for free. Indeed, £51+ was the cheapest rate returned for this service; with the ordinary partnership 5.4% were willing to offer a drafting service for less than £50, implying that the ordinary partnership will on occasion, though not always, be the cheaper option of the two. The partnership is certainly a cheaper option if the LLP charges quoted do not include the cost of drafting the necessary LLP agreement (whether outsourced or not).[639] What is clear, is that the data strongly supports the proposition that the LLP is more expensive to form than the company (£51-150 median bracket), thereby making it a less attractive option for owner-managers.

637 As with the questions in relation to companies and ordinary partnerships, the question was presented as one with a free text answer so as to enable the respondents to independently determine the ranges. The ranges subsequently superimposed on the data correspond with those applied to the companies and partnerships data, to facilitate a direct comparison. Where the response spanned more than one category, the classification was based upon the mean price.

638 30/78.

639 The breakdown was not provided in the survey. If inclusive of a drafting fee, the parity between the partnership and LLP charges indicates that the source of expense is the drafting of the LLP agreement, rather than the Companies House process, seemingly supporting Freedman's observation (n 354) that the lack of internal governance rules for LLPs mean that it is inevitably more expensive to start up than a company.

Figure 132: Price charged to assist an owner-managed business with LLP formation



3.4.4.3 Lack of Knowledge/Information About LLPs

The LLP is the newest of the recognised business forms in the UK, entering a market familiar with well-established companies and partnerships.[640] In order to properly advise owner-managed businesses on the suitability of the LLP form, accountants and other members of the profession will need to be educated to a level sufficient to adequately familiarise themselves with the LLP. They also need to ensure that they are capable of explaining the LLP, along with its benefits and limitations to all clients, including owner-managers. Given the complexity of the form, as previously discussed, this is a challenging and time-consuming task. Whilst it may be reasonable to expect professionals to consider utilising the LLP as an owner-managed business structure, in a world where the existing forms seem to be functioning reasonably well, or are perceived to be functioning reasonably well, the incentive to engage with the LLP on a

640 Alongside this sits the sole trader and limited partnerships, and perhaps trusts and unincorporated associations, though the latter cannot operate with a view to profit. All are outside the scope of this thesis. Prior to the introduction of the LLP, the newest form was the limited partnership, brought into existence by the LPA 1907.

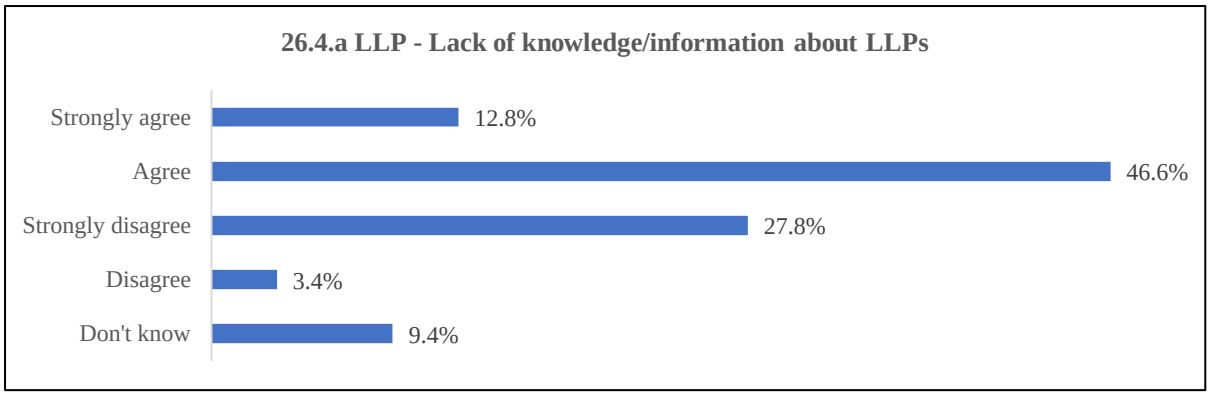
meaningful level is no doubt reduced, even when the cost could be passed on to clients. It may be deemed as sufficient simply to be aware of its existence and core features, with a view to referring the matter to a specialist in the event that the form appears viable (or with a view to talking owner-managers into using a company or partnership instead).[641] Accordingly, the author's survey asked to what extent the respondents agreed that a lack of knowledge and information about LLPs was a disadvantage of the form. The question was asked in an unspecific manner, so could have been interpreted as pertaining to the accountant's own personal understanding or the understanding of the public (or profession) more generally. Interestingly, 3 respondents used the free-text box in relation to difficulties encountered in the formation of the LLP to say that the primary obstacle was their own lack of understanding of the form. 2 more presented the view that explaining the form to owner-managers was problematic. Both sets of unprompted responses indicate that knowledge and information in relation to LLPs is a key problem area.

Returning to the general survey question, the lack of knowledge and information disadvantage ranked second highest in terms of numbers agreeing that this was an issue with LLPs, at a figure of 59.4%[642] (Figure 133).

641 In a free text response, one respondent claimed that he had not encountered any difficulties with incorporating an LLP, but '*in the majority of cases Ltd Cos are more appropriate and I would encourage the client to make that choice instead'*.

642 190/320. Tax ranked first – see Chapter 4.

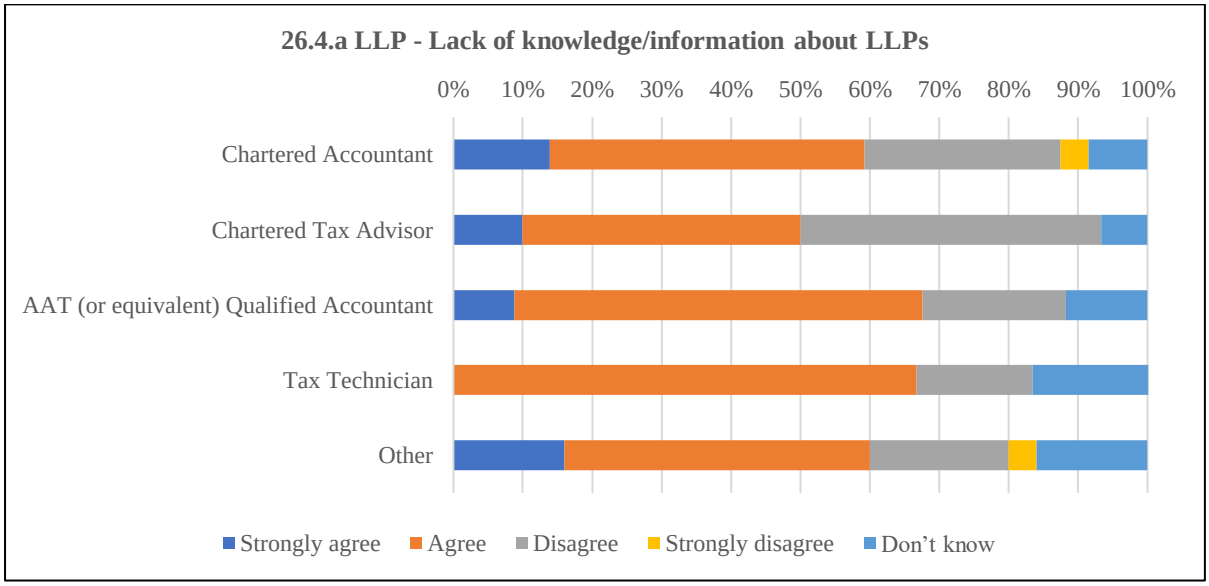
Figure 133: Agreement that lack of knowledge and information about LLPs is a disadvantage



No matter what level of qualification the respondent possessed, all were in overall agreement that there is a lack of knowledge and information about LLPs, but Chartered Tax Advisors are a notable outlier to the extent that a significant proportion (43.3%,[643] which is 11% more than the next closest category of Chartered Accountants) of them disagreed with the proposition that this was a disadvantage of the form for owner-managed businesses (Figure 134).

643 13/30.

Figure 134: Agreement that lack of knowledge and information about LLPs is a disadvantage, by reference to qualification

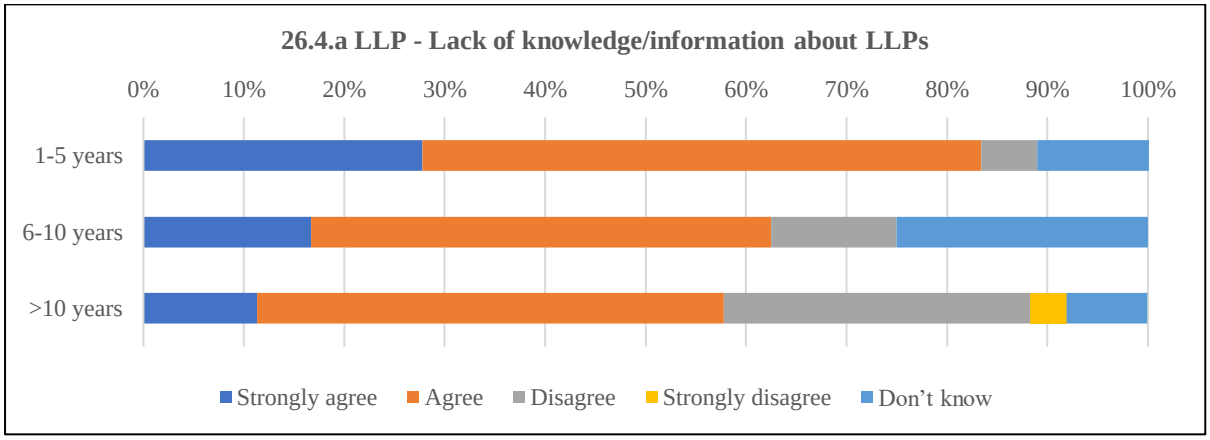


A more stark difference of opinion is evident when the cross-tabulation is performed by reference to the experience of the respondent. 83.4%[644] of the respondents that had been advising for 1-5 years agreed that lack of knowledge and information about LLPs is a disadvantage of the form. This figure reduces to 57.8%[645] in respondents that had been advising owner-managed businesses for more than 10 years (Figure 135). Accordingly, level of understanding correlates with length of time advising owner-managed business; the longer the period, the more likely the individual is to believe that the LLP form is comprehensible, though in all cases the majority still believe that a knowledge and understanding problem exists.

644 15/18.

645 159/275.

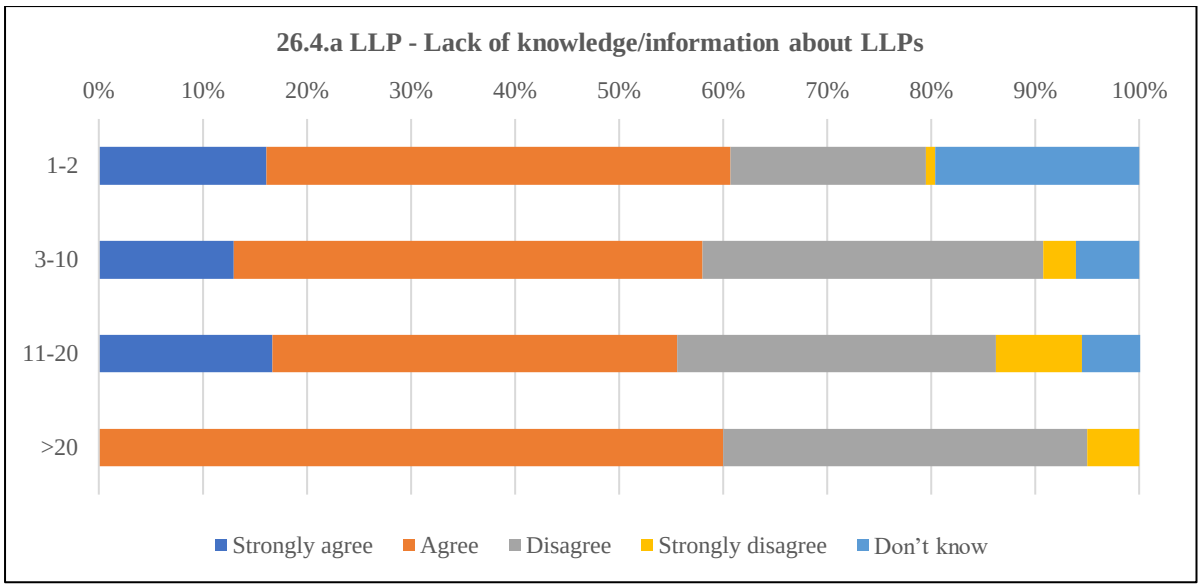
Figure 135: Agreement that lack of knowledge and information about LLPs is a disadvantage, by reference to experience



In relation to firm size variations, there are only marginal differences in the percentages of accountants agreeing that lack of knowledge and information is a disadvantage of the LLP for owner-managed business (with a 0.7% difference between firms with 1-2 accountants and firms with more than 20 accountants), though no respondents in the largest firms strongly agreed with the proposition (Figure 136). Turning to levels of disagreement, accountants in the smallest firms were least likely to disagree (19.7%),[646] though in firm sizes above this the figures were broadly similar; accountants in the smallest firms therefore may have struggled with understanding the LLP more than their larger counterparts.

646 22/112.

Figure 136: Agreement that lack of knowledge and information about LLPs is a disadvantage, by reference to firm size



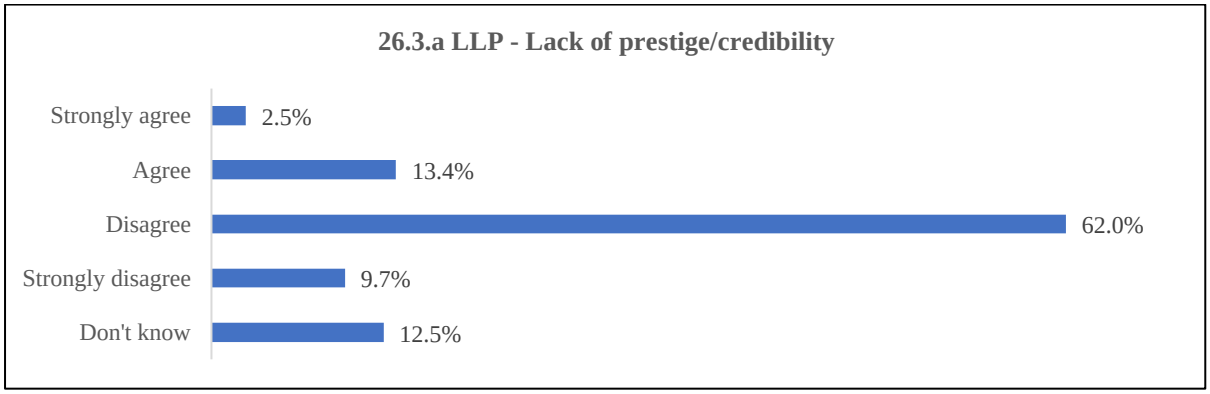
Whilst the cross-tabulated data evidences that differences in opinion do exist as to whether a lack of knowledge and information about the LLP form is a disadvantage, the overall view is that there is indeed a lack of knowledge and information about LLPs, making the form less viable for owner-managed businesses (particularly if those advising owner-managed business do not have a sufficient grasp of the LLP to advise its use in any case). Taxation issues aside, this appears to be a primary concern and arguably a damning indictment for the use of LLPs by owner-managed businesses.

3.4.4.4 Lack of Prestige/Credibility

Due to the fact that the LLP is a relatively young business form, the author considered the possibility that it lacked the prestige and credibility associated with the pre-existing structures. This matter was put to the respondents in the survey, but there was overwhelming disagreement

with the proposition that the LLP lacked prestige and credibility. 71.7%[647] disagreed and just 15.9%[648] agreed. In this respect, the LLP fared better in the opinion of the respondents than the partnership, whereby a small majority of 52.4% disagreed with the proposition that the partnership lacks prestige and credibility, and 44.4% agreed that it does. The figure is lower than that reported for companies, for which 84.9% of the respondents thought that the company was prestigious and offered increased credibility for owner-managed businesses, but the totality of the responses indicate that the corporate forms are generally viewed positively in this respect. Figures 138-140 present the cross-tabulated data on this point.

Figure 137: Agreement that lack of prestige and credibility is a disadvantage of the LLP



647 230/321.

648 51/321.

Figure 138: Agreement that lack of prestige and credibility is a disadvantage of the LLP, by reference to qualification

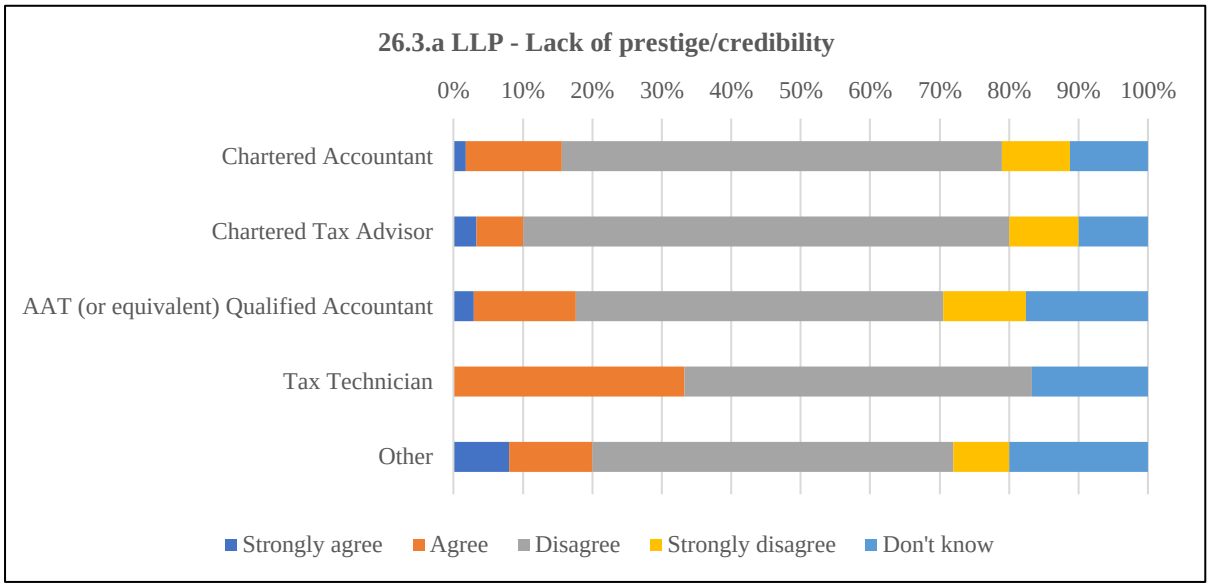


Figure 139: Agreement that lack of prestige and credibility is a disadvantage of the LLP, by reference to experience

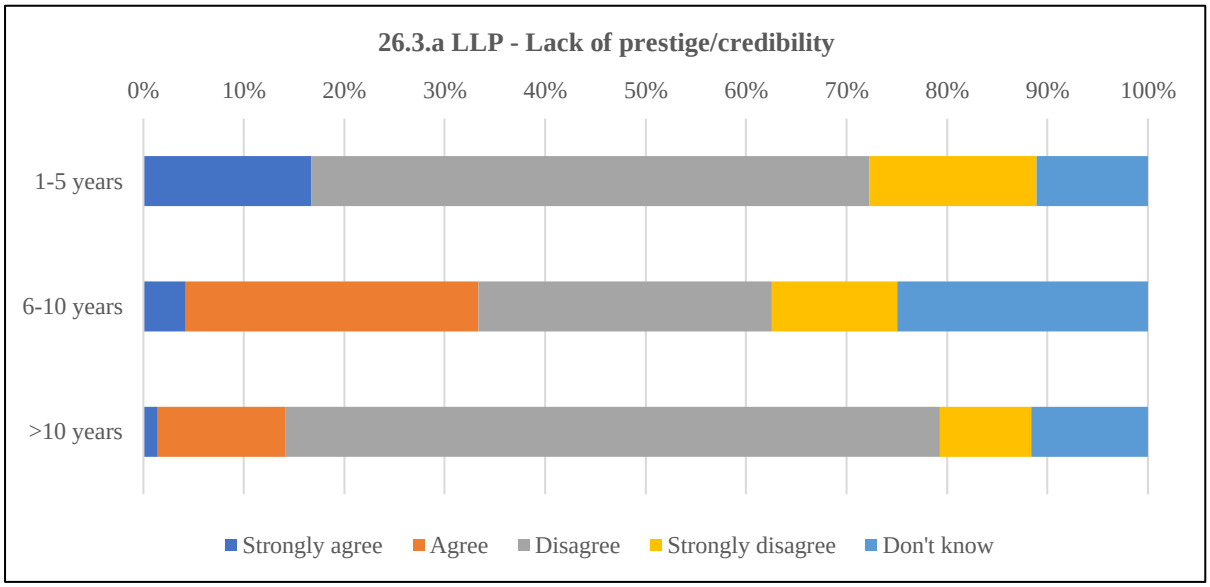
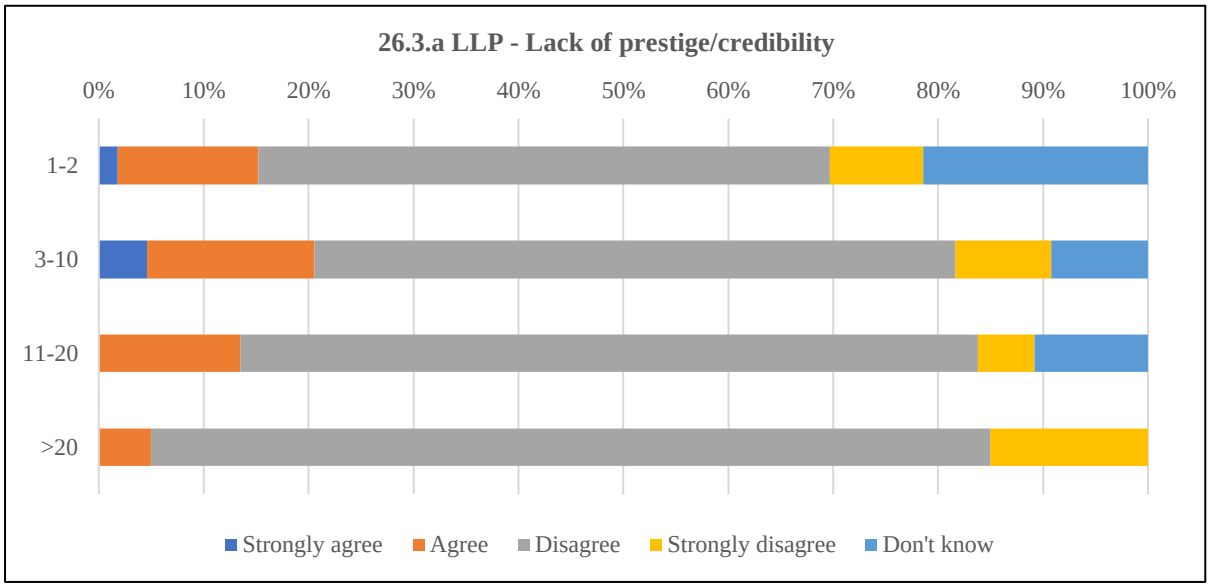


Figure 140: Agreement that lack of prestige and credibility is a disadvantage of the LLP, by reference to firm size



3.5 CONCLUSION

Instinctively, one might be inclined to think that an owner-managed business attracted to the functionality of the ordinary partnership, but in search of limited liability, would naturally adopt or convert to the LLP framework. Given the propensity of owner-managers to provide limited liability as the primary reason for adopting the company form, the case for the LLP seems reasonably strong. The author's survey results suggest that accountants advising owner-managed businesses do appreciate that the flexibility of the partnership structure (which also makes member movements in and out easier and enables retention of a high degree of personal control) with the added benefits of limited liability and separate legal personality make the LLP a potentially attractive form. It is also perceived as being equally prestigious as the company and ordinary partnerships, and on a level playing field with the company form in terms of levels of privacy (though it fares less well than the ordinary partnership). The LLP also offers a

distinct commercial advantage over the company form owing to the lack of need to ensure formal division between ownership and management.

Notwithstanding these benefits, the LLP does not appear to have found favour with owner-managed businesses, and certainly not with non-professional sectors - though the LLP Report suggests relatively high satisfaction rates from those that have taken the plunge. There is no indication that the prospects for LLP usage are any better in the near future. This could lead to scepticism in attributing the decline in the use of the ordinary partnership to the pursuit of limited liability alone, particularly in light of the low partnership-LLP conversion rates. However, the author's survey does highlight two key concerns about the LLP which are linked to the complexity of the form. Firstly, the costs associated with LLP formation are significantly higher than for a company; though it is also true to say that instructing an accountant to draft a partnership agreement is more expensive than company formation services. Secondly, the respondents to the survey highlighted a lack of knowledge and information about the LLP, and its use in the owner-managed business sector, as a barrier to accessibility. In this latter respect, comfort and familiarity with partnerships and companies, combined with the unique corporate LLP form seem to have led to a professional reluctance to take the LLP seriously for owner-managed businesses. Accordingly, in so far as owner-managed businesses (where there is more than one owner-manager) are concerned, the two most commercially viable forms appear to be the company or the ordinary partnership. However, as will be demonstrated in Chapter 4, form selection appears to be driven by much more than these commercial (tax neutral) considerations.

CHAPTER 4: TAXATION AND THE OWNER-MANAGED BUSINESS[649]

4.1 INTRODUCTION

Chapters 2 and 3 explored the commercial (non-tax) reasons for adopting the company, ordinary partnership and LLP forms. Ultimately, the current situation points towards the continuing success of the company, against potentially more bleak prospects for both the ordinary partnership and LLP in so far as owner-managed businesses are concerned. However, it is arguable and probable that this is not completely attributable to the factors discussed thus far. This Chapter will demonstrate how tax considerations are likely to have influenced, and will likely continue to influence, the choice of business form, thereby contributing to the success of the company, and the demise of partnerships. From the owner-manager's perspective (and likewise those who advise them) it would be non-sensical to ignore the impact of taxation upon the overall profitability of the business and the extraction of profits. Accordingly, where there is a significant differential in taxation rates, the selection of form will almost inevitably be influenced by such considerations. Yet that is not how things ought to be, and business form decisions made based upon tax treatment have significant implications for government revenue. Part 2 discusses the revenue matter in more detail. Part 3 introduces basic concepts of good tax design and explains the problems that arise when they are ignored in this context. The remainder of the Chapter is dedicated to the presentation of the author's empirical research alongside the existing literature pertaining to the taxation of different business forms.

649 Discussion of VAT, Stamp Duty Land Tax ("**SDLT**") and business rates have been excluded from this Chapter. They do not discriminate between legal forms in terms of applicable thresholds and rates (though there are complexities involved in applying SDLT to partnerships), and the latter fall outside of the remit of HMRC jurisdiction. Anecdotal evidence suggests that they are not having any significant impact upon the selection of form.

4.2 TAX IMPLICATIONS OF A LARGE PRIVATE SECTOR BUSINESS POPULATION

The rapid growth of owner-managed businesses documented in Chapter 1 is a particular cause for concern if the implications for tax revenue are considered. In 2017, the Office for Budget Responsibility ("**OBR**") forecasted that the growth in owner-managed businesses would result in government revenue being £3.5 billion lower in 2021-22 than if the number of persons in employment grew at the same rate as the self-employed.[650] Whilst the OBR statistics look to the business population as a whole, HMRC calculations specifically address the cost of high levels of incorporation. Also in 2017, HMRC estimated that the total cost to the exchequer of applying lower tax rates to the population of owner-managed companies would be over £9.5 billion by 2021-22.[651] The OBR forecast was based on the assumption that there would be a growth rate of 4% per annum (compared to a 0.3% yearly average growth in employment). Since the average growth rate appears to have been just 3%, the OBR figures are likely to be an overestimate, but the revenue implications will still be significant.[652] The figures may also ultimately be reduced by changes to the dividend allowance[653] and the application of IR35,[654]

650 Office for Budget Responsibility, *Financial Risks Report*, July 2017, 115 <https://obr.uk/download/fiscal-risks-report-july-2017/> accessed 3 April 2022. See also: Carl Emmerson, Paul Johnson and Robert Joyce, *IFS Green Budget 2017*, 7 February 2017 <https://www.ifs.org.uk/publications/8825> accessed 3 April 2022. Adam and Miller (n 4) 3: 'Official forecasts in 2017 implied that lower tax rates for the self-employed and company owner-managers relative to employees would cost about £15 billion in 2021-22' (source not cited). Note that these estimates also cover the financial implications of persons operating as sole-traders, but given the large rise in the number of companies and the associated tax advantages a significant proportion of this figure is attributable to the adoption of the company form by owner-managed businesses.

651 HM Treasury, *Spring Budget 2017*, fn 3 < https://www.gov.uk/government/publications/spring-budget-2017-documents> accessed 3 April 2022.

652 Business Population Estimates 2020 (n 3) 6. Though the growth rate in the year 2016-17 does match the projection: Business Population Estimates 2017 (n 7) 1.

653 Reduced from £5,000 to £2,000 from 6 April 2018: Income Tax Act 2007 ("**ITA 2007**"), s 13A amended by Finance (No.2) Act 2017, s 8(1). Further changes to dividend taxation are likely to be introduced in 2022.

654 A measure designed to counter 'disguised employment'. Now consolidated in ITEPA 2003, Pt 2, Ch 8.

but the OBR maintains that any such changes have not materially changed the fiscal risk posed,[655] and the effects of any changes in taxation rates may not be immediately evident. In any event, the growth in business population is sustained and reasonably consistent; any associated potential loss of revenue, even if the figures are lower than the OBR and HMRC forecasts, is something that requires attention. Of course, as Adam and Miller observe, 'this revenue cost has a corresponding £15 million gain to the taxpayers who benefit from this largesse',[656] but 'the tax advantage is worth less to the taxpayers than the £15 million they save, because in order to get it some of them are doing things they would rather not.'[657] If one considers that the increased numbers are substantially attributable to a rise in the number of owner-managed companies, the taxation of these entities in particular (as compared to other business forms) must come under the microscope. Crucially, one must consider whether the cost can be justified.

4.3 PRINCIPLES OF GOOD TAX DESIGN

From as early as 1723,[658] economists[659] have explored the selection of appropriate criteria in tax design. In doing so, numerous scholars have tried to list 'desirable' characteristics of tax

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655 Office for Budget Responsibility, *Financial Risks Report*, July 2019, 80 <https://obr.uk/docs/dlm_uploads/Fiscalrisksreport2019.pdf> accessed 3 April 2022.

656 Adam and Miller (n 4).

657 Adam and Miller (n 4).

658 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1723-1790 Book V) 825.

659 Unfortunately, lawyers are typically disinterested in such an exercise. Glen Loutzenhiser, *Tiley's Revenue Law* (10th edn, Oxford: Hart Publishing 2022) 6: 'there has been too little participation by UK legal scholars in the debates.'

systems, many of which are familiar to those interested in the topic.[660] Four of those characteristics are key when considering how taxation law should (or should not) affect the selection of business form for owner-managed businesses; equity,[661] neutrality, efficiency, and administration and compliance costs. The criteria simultaneously enable the identification of deficiencies in the law and offer a guide for the consideration of future reforms.

4.3.1 Equity[662]

Horizontal equity, derived from the application of the axiom that similar persons (including legal persons) should be treated similarly,[663] is directly and evidently linked with the taxation

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660 See, for example: Adam Smith (n 658) 825; Robin Boadway and David Wildasin, *Public Sector Economics* (2nd edn, Little, Brown and Company, Boston 1984) 226-7; James Meade (eds), *The Structure and Reform of Direct Taxation*, Institute for Fiscal Studies, 1978; Richard Musgrave and Peggy Musgrave, *Public Finance in Theory and Practice* (4th edn, McGraw-Hill, New York 1984) 224-5; Cedric Sandford, *Economics of Public Finance: An Economic Analysis of Government Expenditure and Revenue in the United Kingdom* (4th edn, Pergamon Press, Oxford 1992) 111-7; Joseph Stiglitz and Jay Rosengard, *Economics of the Public Sector* (4th edn, W W Norton & Company Inc, New York 2015) 511-512; Henry Simons, *Personal Income Taxation* (University of Chicago Press 1938); Christopher Heady, 'Optimal Taxation as Guide to Tax Policy: A Survey', Fiscal Studies (1993) vol. 14, no. 1, 15-41.

661 To use the single notion of 'equity' might be regarded as misleading, since it is typically understood to comprise of two separate concepts: *vertical equity* and *horizontal equity*. Vertical equity is concerned with how tax liabilities are arranged among people whose circumstances are acknowledged to be different: with the distributive and redistributive implications of taxation, with the 'rich' and the 'poor': J Kay and M King, *The British Tax System* (5th edn, OUP 1990). This is linked with the 'ability to pay' idea, explored in detail by many, including *inter alia*: John Pointon and Derek Spratley, *Principles of Business Taxation* (Clarendon Press, Oxford 1988); Meade Report (n 660) 12; Stiglitz and Rosengard (n 660) 403-4; Musgrave (n 660) 62; James Banks and Peter Diamond, 'The Base for Direct Taxation' in Stuart Adam and others (eds), *Dimensions of Tax Design: The Mirrlees Review* (OUP 2010); Liam Murphy and Thomas Nagel, *The Myth of Ownership* (OUP 2002); Louis Kaplow, *The Theory of Taxation and Public Economics* (Princeton University Press, Princeton 2008) 391-406; Anthony Atkinson and Joseph Stiglitz, *Lecture on Public Economics* (McGraw Hill, London 1980). This Chapter focuses upon horizontal equity only, as the discussion is centred upon the appropriate treatment of owner-managed businesses *across different forms*, rather than the rates of taxation that should be applied to those who derive *different levels of income* from such enterprise.

662 Richard Musgrave, 'Horizontal Equity: A Further Note' (1993) 1 Florida Tax Rev 354, 355: 'I … begin with the observation that almost everyone agrees with the [horizontal equity] rule, which calls for equal treatment of people in equal positions. The general principle of [horizontal equity] is almost universally accepted.'

663 Kay and King (n 661) 41.

of different business forms. In the context of discussing the 'tax penalty' on employment, Adam and Miller explain:[664]

> [t]here has always been (and will always be) a grey area between legal forms…the potential for unfairness is clear when two people earning similar incomes from similar work are treated differently because they use different legal forms. Yet, even when two people earn similar incomes from very *different* activities, it might be considered unfair to tax them differently. The crucial question in applying the principle of horizontal equity is always what dimensions, or criteria, are relevant in assessing whether people are 'similar'. It is doubtful that merely providing different kinds of services obviates the imperative for equal treatment if the services are equally valuable to the people paying for them.

Crucially, where different legal forms are taxed in different ways a justification for regarding the activities conducted as materially different, which can adequately account for the differential treatment, must be offered i.e. it must be evident why seemingly similar activity is not, on closer inspection, actually the same. Alternatively, this criterion may give way to other compelling reasons, but they must be clearly identifiable.

4.3.2 Neutrality

A neutral tax is one that avoids distortions of the market.[665] Though, in light of the basic truth that any tax will likely result in at least some market effects,[666] the quest might be better described as one for the maximum neutrality for any given burden.

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664 Stuart Adam and Helen Miller, 'Principles and Practice of Taxing Small Business' in Glen Loutzenhiser and Rita de La Feria (eds), *The Dynamics of Taxation: Essays in Honour of Judith Freedman* (Oxford: Hart Publishing 2020) 103.

665 Loutzenhiser (n 659) 10; Kay and King (n 661) 19.

666 Objections to the use of neutrality as a criterion of design have been raised. One notable source is Murray Rothbard, *Power and Market: Government and the Economy*, Institute for Humane Studies (California 1970) 65, 102. He argues that a neutral tax is a chimera or a mirage. This, in his view, is attributable to the fact that the object of a neutral tax is to leave the market in the same condition as it was without taxation. Accordingly, since any tax will result in some form of distortion, no tax can ever truly be

> Since taxation is compulsory and the market is a system of voluntary exchange, the levying of any tax constitutes a derogation from the market system. This derogation is least if the tax system is neutral between alternatives facing the taxpayer…[t]he taxpayer's freedom of choice is maximised because the distortion of his choice is minimised. [667]

Essentially, neutrality both requires and involves the taxation of *choices* in an equal manner. The tax system should not provide incentives that would distort the range of individual's choices that would otherwise be determined by sound practical considerations, such as those considered in the previous two Chapters. The neutrality criterion has two important aspects:

(a) Firstly, where distortions are introduced, neutrality demands that an appropriate justification is provided (such as the correction of market failures);[668]

(b) Secondly, it provides a basis for criticism of any rule which breaks the principle of neutrality without a satisfactory justification.

Incoherent systems of taxation can cause many kinds of distortion, but most important for the present discussion is the fact that it may lead to the substitution of one form of business

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neutral. 'There is no such thing as a neutral tax…just as there is no such thing as neutral money'. It follows that '[e]conomists and others may try to approximate neutrality, in the hopes of disturbing the market as little as possible, but they can never fully succeed.' It is undoubtedly true that no tax will leave the market entirely undisturbed, but it does not follow that '*at a given level of tax revenue* no tax can be neutral in the sense of minimising the distortion of the market': Barry Bracewell-Milnes, 'A Liberal Tax Policy' [1976] British Tax Review 110, 111. Kay and King (n 661) 19: 'Fiscal neutrality does not imply that a tax system has no effect on behaviour. No tax system which collects revenue can have that property. A structure approaches fiscal neutrality if it does not impose very different rates of tax on essentially similar activities.'

667 Bracewell-Milnes (n 666).

668 Kay and King (n 661) 9 'The neutral tax system, in effect, provides a bench-mark against which non-neutralities, intentional or otherwise, can be judged.'

organisation for another i.e. individuals who may otherwise operate as a partnership would choose to form a company in order to obtain tax advantages.[669] It can also distort choices in relation to behaviour within legal forms, such as the decision to withdraw or invest profits in the business itself.[670] Differences in tax treatment currently exist across the spectrum from employees to the self-employed (including sole-traders, partnerships and owner-managed companies) and create opportunities for taxpayers to reduce their tax liability and social security contributions.[671] The majority of current academic literature focuses on the boundary between the employed and self-employed, but even within the self-employment category, 'the tax system should not discriminate between legal forms.'[672] Neutrality demands that this must be the starting point and, as noted above, any departures from that starting point need to be justified; this might be by reference to the other principles of tax design, or because it is proper to take into account that differences in legal form do have real practical consequences.[673] Crawford and Freedman have made the following observations in this context:

> [t]he relative effective tax rates paid on income earned in the corporate and non-corporate sectors often favour one legal form over another. Which form is favoured will depend on all the circumstances of the taxpayer, particularly in a system which has a progressive personal income tax, and on the structure of the tax system. Thus, in the USA, there has been a tax penalty on incorporation for those intending to distribute profits as a result of the classical system of dividend taxation which taxes dividends both at the corporate level (via corporation tax) and at the personal level (via income tax). This was tackled in 1958 by way of Subchapter S to the Internal Revenue Code which permits partnership or pass-through treatment for US corporations satisfying certain conditions ('S' Corps). Thus many US firms may now choose incorporation without tax penalty and, in

669 Meade Report (n 660) 9.

670 Adam and Miller (n 4) 10.

671 Crawford and Freedman (n 5) 1029. This thesis endorses the view that one cannot look at the forms of business in isolation but must regard them as being part of a spectrum.

672 Crawford and Freedman (n 5) 1030, 1039.

673 Crawford and Freedman (n 5) 1032.

> practice, the S Corp may have some tax advantages over unincorporated structures: for example, despite the pass-through treatment, the majority of the S Corp's profits escape various employment, social security and healthcare payments, and taxes, so the S Corp offers an opportunity to escape both labour taxes and the double taxation of corporate dividends. This led to an estimated loss of $5.7 billion in employment taxes in 2000... Indeed, this Treasury report describes the S Corp form as 'a multibillion dollar employment tax shelter for single owner businesses'. It is significant that in 2000, nearly 80% of all S Corps were either entirely or majority owned by a single shareholder. Since 1997, under the check-the-box regulations, US entities other than corporations may elect to be treated for tax purposes either as a corporation or on a pass-through basis. The LLC hybrid form can also give limited liability with partnership tax treatment. These developments give many US businesses a choice of tax treatment regardless of legal form, but they also increase the opportunities for tax planning.[674]

A breach of the principle of neutrality can have the undesirable effect of leading owner-managed businesses to adopt an inappropriate business form. As discussed in Chapter 2, the administrative burdens imposed on company owner-managers, and the necessary separation of personal and business assets is a matter to be taken seriously; adopting the company form is not a decision to be taken lightly, and certainly should not be driven by taxation-based considerations.

[674] Crawford and Freedman (n 5) 1046-7.

4.3.3 Efficiency

The emphasis on efficiency is typically championed by those associated with the optimal taxation school of thought,[675] with a focus upon the 'maximisation of a social welfare function',[676] and Pareto efficiency:[677]

> [t]he criterion of Pareto efficiency has an important property that requires comment. It is *individualistic* in two senses. First, it is concerned only with each individual's welfare, not with the relative well-being of different individuals. It is not concerned explicitly with inequality. Thus, a change that made the rich better off but left the poor unaffected would still be a Pareto improvement … Second, it is each individual's perception of his or her own welfare that counts. This is consistent with the general principle of consumer sovereignty, which holds that individuals are the best judges of their own needs and wants; that is, of what is in their own best interests ...'

A resource allocation which improves the position of one person more than it decreases the utility of another is desirable since it is closer to the Pareto efficient ideal. If a tax disrupts the resource allocation, or makes the existing allocation worse, it generates a 'deadweight loss' and cannot be regarded as optimal.[678] Whilst those who do not subscribe to the optimal taxation school of thought may be sceptical of employing efficiency concepts in tax design, a focus on efficiency is clearly apt when considering how individuals ought to structure their business ventures. If the selection of business form is driven by tax considerations, the deadweight loss generated by such behaviour is self-evidently undesirable.

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675 James Mirrlees, 'An Exploration in the Theory of Optimum Income Taxation', The Review of Economic Studies, Vol 38, No. 2 (April 1971) 175-208.

676 Kaplow (n 661) 391-406.

677 Stiglitz and Rosengard (n 660) 65-66, 608. See also Joseph Stiglitz, 'Self-selection and Pareto-Efficient Taxation', Journal of Public Economics 17 (1982) 213-240; Joseph Stiglitz, 'Pareto Efficient and Optimal Taxation and the New Welfare Economics', in Alan Auerbach and Martin Feldstein, *Handbook of Public Economics* (Amsterdam and New York: North Holland, Elservier Science Publishers 1987) 991-1042.

678 Mirrlees Review (n 661), *The Economic Approach to Tax Design*, 29.

The efficiency criterion also has a close relationship with the neutrality principle, and revenue losses. For example, when the range of choice is distorted by tax considerations:

> this ultimately reduces society's aggregate output and wellbeing…their financial gain in reduced tax payments is mirrored by an equal loss of revenue to the government while there is an additional (financial or non-financial) loss to the individuals for not doing as they would have preferred in the absence of taxation.[679]

4.3.4 Administration and Compliance Costs

Administration costs are those incurred by a tax authority in establishing and operating systems to manage all aspects of taxation e.g. HMRC's running costs.[680] Compliance costs, in contrast, are incurred directly by taxpayers in complying with their tax-related obligations, and by third parties involved in the tax remittance process. Mandatory compliance costs imposed upon taxpayers in order to meet their statutory obligations are key considerations and a source of concern for many small-business owners, especially where the costs are not anticipated when the business is a start-up. The Meade Report[681] observed that ease of understanding by the taxpayer and simplicity of administration are frequently combined, but they are not necessarily found together:

> [t]he old purchase tax levied on consumption goods at the wholesale stage was to all intents and purposes a tax on consumption; but a tax on retail sales of

679 Adam and Miller (n 4) 8.

680 The main HM Revenue & Customs administration costs in the year 2015-16 amounted to £3.58bn – 63% (£2.3bn) were attributable to staffing. HM Revenue & Customs, 'Annual Report and Accounts 2015-16 – Executive Summary', July 2016, 44 <https://www.gov.uk/government/publications/hmrc-annual-report-and-accounts-2015-to-2016> accessed 3 April 2022. Kay and King (n 661) 8, take the view that the formal incidence of tax is generally irrelevant to its effective incidence: 'It makes little practical difference to the incidence of tobacco tax whether it is levied on importers, wholesalers, manufacturers, retailers or individual smokers; and the sensible decision is to impose the legal liability at the point at which the tax can be collected most cheaply and conveniently.'

681 Meade Report (n 660) 19-20.

> goods, levied directly as payment was made for them over the counter by the consumer for personal consumption would have been easier than the purchase tax for the consumer to recognise as a tax on consumption. It would, however, have constituted a more difficult task for the tax authorities to administer, control and enforce.

There is evidence to suggest that compliance costs tend to impose a greater burden on taxpayers than the official administrative costs borne by HMRC.[682] That may be the case even where the tax is simple and precise. Crawford and Freedman[683] note that compliance costs fall disproportionately upon small businesses which generally have fewer staff and less expertise and time to devote to understanding their tax liabilities. Slemrod[684] suggests that greater non-compliance by small businesses may, in fact, offset their regressive compliance burden.[685] Adam and Miller have also considered the matter, noting that both evasion and avoidance are higher amongst small business owners;[686] they have a greater scope to misreport income and deductions due to the fact that they are not subject to third-party reporting (unlike employees).[687] The resulting shortfall – the difference between the tax which ought to be paid and the tax actually paid – is known as the 'tax gap'. HMRC estimated the 2019-20 tax gap for

682 Meade Report (n 660) 20. See also Cedric Sandford, *Tax Compliance Costs Measurement and Policy* (Fiscal Publications, Bath 1995).

683 Crawford and Freedman (n 5) 1080; see also Cedric Sandford, Michael Godwin and Phillip Hardwick, *Administrative and Compliance Costs of Taxation* (Fiscal Publications, Bath 1990); Francis Chittenden, Saleema Kauser and Panikkos Poutziouris, 'The Impact of Tax Regulation on Small Firms in the UK, USA, EU and Australia and New Zealand' (2003) International Small Business Journal, 93; Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs', eJournal of Tax Research 1 (2003) 64; KPMG (n 273).

684 Joel Slemrod, 'Small Business and the Tax System', in Henry Aaron and Joel Slemrod, *The Crisis in Tax Administration* (Washington DC: Brookings Institution Press 2004).

685 On non-compliance and compliance costs see OTS Small Business Taxation Interim Report (n 273) 20.

686 Adam and Miller (n 664) 106.

687 Stuart Adam and others, *Frictions and Taxpayer Responses: Evidence from Bunching at Personal Tax Thresholds*, Institute for Fiscal Studies, 2019, 20 <https://ifs.org.uk/publications/14979> accessed 3 April 2022.

income tax, NICs and CGT, from business taxpayers (sole traders and small partnerships) was £4.3 billion.[688]

However, as noted by Crawford and Freedman[689] there is likely to be greater revenue collection if compliance is encouraged by making it less costly. This may also have the indirect effect of making enforcement easier where there is non-compliance. In terms of tax design, the criteria favours a system which is comprehensible and accessible to even the smallest businesses, no matter what the legal form adopted. The importance of reducing such costs has been openly acknowledged by HMRC which continues to monitor and assess the impact of taxation law and policy changes upon businesses.[690] One important matter to bear in mind is that, as a general rule, the more complex the tax system, the more burdensome its administrative and compliance requirements will be:

> the presence of boundaries in the tax system creates the need to devise, administer, comply with and police rules to distinguish the different legal forms. These, in turn, impose costs by diverting officials, taxpayers, accountants and occasionally the courts from more productive activities – all to a greater extent, the bigger the tax differential on either side of the boundary.[691]

Accordingly, where boundaries exist, they must do so for good reason, and should be as comprehensible as possible to owner-managed businesses and their advisors.

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688 HM Revenue & Customs, *Measuring Tax Gaps 2021 Edition – Tax Gap Estimates for 2019 to 2020,* 16 September 2021 <https://www.gov.uk/government/statistics/measuring-tax-gaps/measuring-tax-gaps-2021-edition-tax-gap-estimates-for-2019-to-2020#income-tax-national-insurance-contributions-and-capital-gains-tax> accessed 3 April 2022. In 2015-16, the majority of sole traders and small partnerships underdeclared their tax liabilities by more than £1,000. The equivalent figures for 2019-20 are not available.

689 Crawford and Freedman (n 5) 1081.

690 Matt Colahan and others, HM Revenue and Customs Research Report No.375, *Understanding Tax Administration for Businesses,* July 2015, 12.

691 Adam and Miller (n 664) 106.

4.4 TAXATION AND THE SELECTION OF BUSINESS FORM

With the above principles in mind, the author's research also explored the possible effects of tax considerations on the selection of business form, with a view to considering how this might have impacted upon the use of partnerships in particular. That is not to say that it is impossible, in some instances, for owner-managers to derive tax benefits from operating in a partnership rather than a company but, as will be demonstrated, on balance, the company is typically perceived as the more tax efficient form of the two. One thing to bear in mind throughout is that there 'is no general partnership tax code, or partnership tax act'. Accordingly, a tax code designed for, and applicable to, sole traders is stretched to accommodate the partnership structure, which is not always a comfortable fit; this is particularly true in respect of CGT (Part 4.5.4). Some have expressed the view to the effect that 'partnerships are treated as something of a poor relation when it comes to tax changes. It is questionable how much they are considered when significant changes are considered…' and therefore 'wonder if partnerships have been properly factored into the [business taxation] framework.'[692] However, one should not expect a partnership tax code anytime soon, as the appetite appears to be lacking: 'although it does have the potential to deliver codification and so some simplification in the long term, it would be a major project, consume considerable resources on all sides and cause much disruption and uncertainty.' [693] At present, the reform is perceived as too radical to be deemed feasible, and it is doubtful that much will be achieved in absence of other substantive changes to the taxation of partnerships and companies respectively – this is not considered any further.

692 OTS Partnerships Interim Report (n 33) 15.

693 OTS Partnerships Interim Report (n 33) 15.

Another important factor to consider is that the level of turnover across owner-managed partnerships will vary significantly and necessarily impact upon the taxation treatment of the owner-managers themselves.[694] The OTS has noted the high percentages of low turnover partnerships[695] which is complimentary to the existence of a high number of low-productivity businesses in the UK.

> We have been struck by the statistics we have received from HMRC on small partnerships:
>
> - 10 per cent have no turnover;
> - 33 per cent have turnover under £30,000;
> - 55 per cent have turnover under £75,000;
> - 79 per cent have turnover under £250,000. [696]

The propensity of (sometimes rather large) professional businesses to use the partnership form results in the mean average income figures being unrepresentative of the position of a significant proportion of owner-managing partners. The OTS has also appreciated this point: '[t]he mean turnover for partnerships is significantly higher than the median, as the mean is skewed upwards by a relatively small number of partnerships with high turnover.'[697] Cribb, Miller and Pope's research further confirms that the mean income is a particularly unreliable measure in so far as partners are concerned:[698]

> [p]artners are significantly over-represented in the top 1% of all income taxpayers. 7% of all partners are in the top 1% of income taxpayers and together they earn 60% of all partnership income. This is an extremely top-heavy

694 Cribb, Miller and Pope (n 4) 10.

695 OTS Partnerships Interim Report (n 33) 18.

696 OTS Partnerships Interim Report (n 33) 18.

697 OTS Partnerships Interim Report (n 33) 61.

698 Cribb, Miller and Pope (n 33) 6, 11.

> distribution of income, reflecting both the very high incomes of some partners and the very low incomes of many others…
>
> The mean income of partners in the financial services industry is £308,000, with 37% of partners in that industry in the top 1% of taxpayers.

The mean income for partners across all industries is presented as being £74,000, though the median stands lower at £23,000. By way of comparison, the mean income for a company owner-manager is stated to be £43,000 - 2% are in the top 1% of taxpayers – with the median income reported as £32,000.[699] To a certain extent, the figure for company owner-managers is also misleading since it does not take account of the fact there can be retention of profits within the company. This is linked to tax planning, which is discussed further at 4.5.2. In any case, the typical owner-managed business is not a high turnover enterprise, making potential tax savings all the more attractive.

A more comprehensive account of the possible effects of different taxes upon the selection of form by owner-managers is provided in Part 4.5. The following tables provide a summary of the rates and thresholds for the main income (including National Insurance Contributions ("**NICs"**)) and capital taxes as applicable to partners and company owner-managers respectively.

699 Cribb, Miller and Pope (n 4) 6-7, 17.

Figure 141: Table of differences in income and capital taxes[700]

Partners	Company owner-managers
Income tax charged on profits (above personal allowance). Self-employed NICs (Class 4) charged on business profits (above lower profits limit) at a rate lower than employee NICs. Small flat rate per week (Class 2). No equivalent of employer NICs. CGT (above annual exempt amount) on the disposal of business assets, at a reduced rate if qualifying for business assets disposal (BAD) relief.	Income tax and employee and employer NICs on salary as for employees, taken out of the company's pre-tax profit. Corporation tax on a company profits (after salary deducted), including capital gains on disposal of company assets. Income tax on dividends (distributed out of post-corporation-tax profits) above dividend allowance. CGT (above annual allowance) on sale of shares, at reduced rate if qualifying for BADR.

700 Adapted version of Adam and Miller (n 4) 32; Cribb, Miller and Pope (n 4) 7.

Figure 142: Table of statutory allowances and tax rates 2021-2022[701]

	Starting threshold	Basic rate	Higher rate	Additional rate
Employer NICs	£8,840	13.8%	13.8%	13.8%
Employee NICs	£9,568	12%	2%	2%
Self-employed NICs	£9,568	9%	2%	2%
Income tax on earnings	£12,570	20%	40%	45%
Income tax on dividends	£2,000	7.5%	32.5%	38.1%
CGT	£12,570	10%	20%	20%

701 Updated version of Adam and Miller (n 4) 33. Employer and employee NICs thresholds depend on pay period; figures shown are annual. Self-employed NICs here refers to Class 4 contributions. The starting threshold for dividends (dividend allowance) is in addition to the income tax personal allowance. CGT rates are for personal assets other than residential property and carried interest. When calculating which income falls within each band, capital gains are treated as the top slice of income, followed by dividends, savings (not shown), and then other income.

In Scotland, income tax rates are different (accordingly, the summaries and examples herein are not accurate calculations for the Scottish law position). In the 2021/22 tax year, the applicable income tax rates in Scotland were:

- Personal allowance - £12,570;
- Starter rate 19% - £12,571 to £14,667;
- Basic rate 20% - £14,668 to £25,296;
- Intermediate rate 21% - £25,297 to £43,662;
- Higher rate 41% - £43,663 to £150,000;
- Top rate 45% - over £150,000.

From 6 April 2022, there is a temporary 1.25% increase in Class 1 (employer and employee) and Class 4 (self-employed) NICs, in addition to a 1.25% increase in the dividend tax rate. From 6 April 2023, it is anticipated that the NICs rates will return to 2021-22 levels, and a new, separate, Health and Social Care Levy (at 1.25%) will be introduced. See HM Revenue & Customs, *Guidance: Prepare for the Health and Social Care Levy*, 31 January 2022 <https://www.gov.uk/guidance/prepare-for-the-health-and-social-care-levy> accessed 30 March 2022. To the author's knowledge, there is no published position on whether the dividend tax rate will be reduced in the 2023-2024 tax year (following the introduction of the separate levy).

From 6 July 2022, the thresholds for Class 1 and Class 4 NICs were raised to match the income tax thresholds: National Insurance Contributions (Increase of Thresholds Act) 2022, s 1.

These tax changes may be reversed in the near future. This uncertainty means that the author has chosen to present the calculations in this Chapter by reference to the 2021-2022 tax year, which also reflect the position during which the author's empirical research was conducted and analysed.

CGT with BAD relief	£12,570	10%	10%	10%
Corporation tax	£0	19%	19%	19%

The applicable rates and thresholds have, inevitably, changed significantly over time, and there is a high likelihood that the gulf in tax treatment of different forms will narrow, and perhaps widen again in years to come, especially given the need to generate revenue following the financial impact of the COVID-19 pandemic. This relative treatment primarily varies with changes to income tax, CGT, the taxation of dividends, and the corporation tax regime. By way of example, '[s]ignificant reductions in marginal income tax rates in 1988 swung the pendulum of tax planning away from incorporation (which had sought to avoid historically high marginal income tax rates) and back to the use of unincorporated trading vehicles.'[702] Since then, the focus has returned to the tax benefits of incorporation. The liability of owner-managers fell in the early 2000s with the introduction of a 'starting rate' of corporation tax, which then increased when the starting rate was effectively abolished in 2004-05.'[703]

> Successive governments have made a number of changes to corporation tax [designed to stimulate growth]…[a]s a result the main corporation tax rate was reduced from 28% to 26% at April 2011, to 24% from April 2012, 23% from April 2014 and will be [was] further reduced to 20% from April 2015. As corporation tax rates have fallen a gap has been created between personal tax rates and tax paid via the company structure which may be encouraging incorporation.[704]

[702] Constable (n 429) 45.1.

[703] Adam and Miller (n 664) 100, fn 6: 'A "starting rate" of corporation tax meant that the first £10,000 of profit was subject to a lower tax rate, set at 10% in 2000-02. In 2004-05 and 2005-06, profits distributed to shareholders were subject to a 19% tax rate (equivalent to small companies' tax rate), which ended this tax advantage for most owner-managers.'

[704] HMRC Reasons Behind Incorporation (n 25) 6.

In April 2017, the UK corporation tax rate was set at 19% and, to date, has not been changed. Turning to the effects of such changes, international comparisons indicate that levels of business ownership, on more a general level, have been affected by the tax regime:

> [i]t is not (currently) known how much of the growth in UK business ownership that has been taking place since the 1970s and accelerated since the early 2000s is caused by tax. But alongside plenty of anecdotes that tax matters, the comparison with other countries provides suggestive evidence that tax has at least been a contributing factor; the growth in self-employment is not common across OECD countries, with most seeing little change (or reduction) in business ownership since 2000. The only OECD country which has a larger rise in self-employment in the UK has been the Netherlands, which also stands out internationally for having lower taxes on business owners…Given the scale of tax differences across legal forms in the UK it would be extremely surprising if tax (in combination with other factors such as the rise of technologies that allow people to work via online platforms) were not helping to shape the labour market.[705]

The relationship between tax rates and levels of incorporation appears to be more easily identifiable. Adam and Miller comment:

> [t]he UK provides a clear illustration of how incorporation responds to incentives…Spikes [in the number of incorporations over time] occurred at times when the incentives, or at least the perceived incentives, to incorporate changed. The increase in incorporations in response to the 0% starting rate of corporation tax in the early 2000s was predictable and, indeed, predicted by researchers at the Institute for Fiscal Studies (IFS).[706]

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705 Adam and Miller (n 4) 36.

At present, the main corporation tax rate for non-ringfenced profits above £250,000 is set to increase to 25% with effect from 1 April 2023. A small profits rate of 19% will apply to the lower limit of £50,000. A graduated rate will apply between the two thresholds. However, this is an area of great political uncertainty. For the position at the time of publication see: HM Revenue & Customs, *Policy Paper: Corporation Tax Charge and Rates from 1 April 2022 and Small Profits Rate and Marginal Relief from 1 April 2023*, 3 March 2021 <https://www.gov.uk/government/publications/corporation-tax-charge-and-rates-from-1-april-2022-and-small-profits-rate-and-marginal-relief-from-1-april-2023/corporation-tax-charge-and-rates-from-1-april-2022-and-small-profits-rate-and-marginal-relief-from-1-april-2023> accessed 6 August 2022.

706 Adam and Miller (n 664) 104 and Figure 4.

The HMRC 'Reasons behind incorporation' Report supports the theory that a significant number of incorporations are, and have been, tax driven. The reported findings were that after limited liability:

> [t]he next most commonly unprompted cited reason for incorporating was tax and National Insurance savings (19 per cent cited it then), though it was the fourth most widely cited reason after prompting (61 per cent mentioned it then). Most respondents thought it was very or fairly common (63 per cent) for UK businesses to incorporate in order to reduce tax liabilities.[707]

Adam and Miller's research also led them to conclude that:

> there is strong evidence that it [tax] does affect behaviour. Usually it would be better for people to do what they think best personally and commercially [independent of tax considerations]…[t]he large tax rate differences between legal forms and the inefficiency they create are easy to see.[708]

Such observations are not new. As part of the Mirrlees Review, published in 2011, Crawford and Freedman claimed that '[t]he UK experience lends strong support to the argument that the tax system should not set out to favour one legal form over another.'[709] The OTS, in two separate reports, has also expressed concerns in relation to the effects of taxation upon the selection of business form. '[The] [s]ole trader or partnership is the more natural form

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707 HMRC Reasons Behind Incorporation (n 25) 2-3. This was also reported as the second perceived main benefit of incorporation after the event: 'Having incorporated the second main benefit of incorporation was the tax and NI savings (20% unprompted, 47% after prompting).'

708 Adam and Miller (n 4). They also note that the current tax base also affects behaviour in other significant ways, but that is beyond the scope of this thesis which focuses upon the adoption of business form alone. This relates to 'the level of investment and risk-taking, asset allocations and financing decisions – which also affect individuals' welfare and aggregate productivity. These problems are less widely understood and there is less evidence on their exact magnitudes – but that in itself does not make them less important. They are, however, less pressing in the current environment, with low capital income tax rates and ultra-low interest rates, than they would be if either of those increased.'

709 Mirrlees Review (n 661) Chapter 11.

for many small businesses but tax incentives, both past and present, have encouraged many businesses to incorporate.'[710] 'Once incorporated, the individual continues to conduct the same business, but now with a significantly different tax treatment that often results in a lower tax charge following analysis and planning. This could be seen as creating an inequity in the tax system generally.'[711]

Interestingly, the HMRC Reasons Behind Incorporation Report observed that 'those who mentioned tax or NI savings as a motivation for incorporation were more likely than other respondents to have got the idea to incorporate from an accountant (39 per cent of those with a tax/NI motivation got the initial incorporation idea from an accountant)'.[712] Given this level of influence and experience of advising business owner-managers, the perceptions of the accountancy profession on the relative tax benefits of companies and partnerships respectively, and the importance of the individual taxes to business owner-managers, are highly relevant in determining the existence of a relationship between the tax system and the decline in the use of partnerships. The author's research explored both points.

The survey respondents were prompted to consider whether the tax treatment of a company (in a general sense) was an advantage of operating through a company for an owner-managed business. An overwhelming majority of respondents agreed with this proposition, (93.9%),[713] and a significant proportion did so strongly (46.1%).[714] Overall, this ranked third

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710 OTS Disincorporation Relief (n 200) 5.

711 OTS Small Company Taxation Review (n 40) 24.

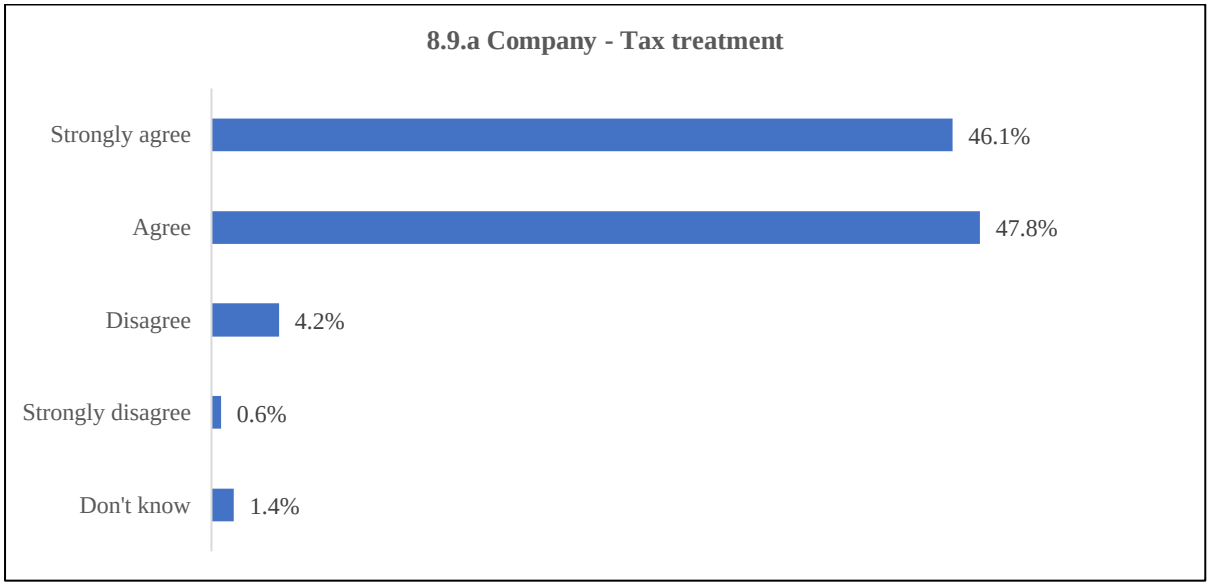
712 HMRC Reasons Behind Incorporation (n 25) 21, 23: '[Businesses] were also more likely to have sought paid advice if they were in a partnership prior to incorporation (77 per cent). One potential implication for this is that the tax implications are more complicated than for a sole trader.'

713 338/360.

714 166/360.

in the list of company advantages, just 4.5% lower than the percentage registered for limited liability, and 1.1% less than separate and continuing legal personality; it thereby features highly in terms of perceived company advantages.

Figure 143: Agreement that tax treatment is an advantage of the company[715]



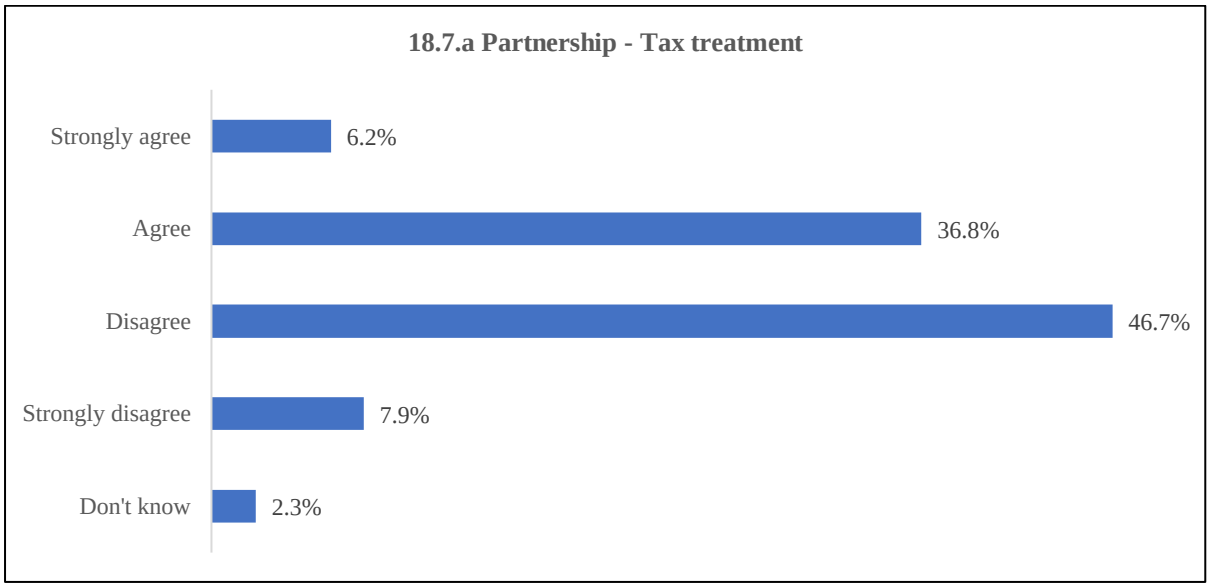
Turning to ordinary partnerships, the survey also prompted the respondents to consider whether the tax treatment of such partnerships was an advantage of the form. Only 42.4%[716] agreed with that proposition, with the majority (46.7%)[717] reporting disagreement.

715 Cross-tabulated data has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

716 152/353.

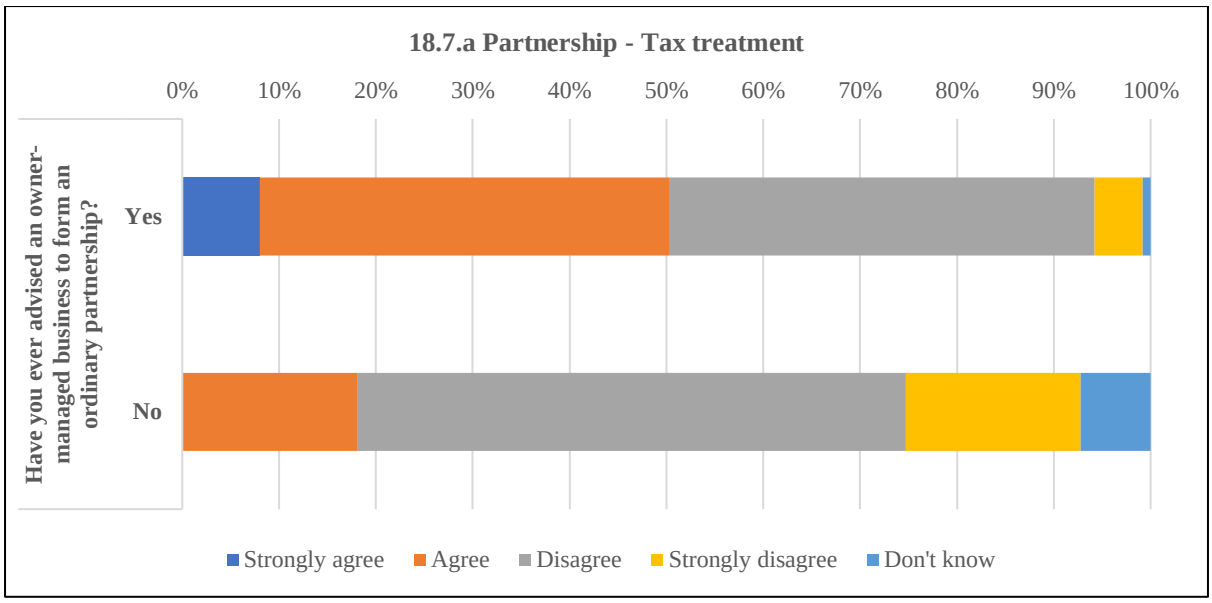
717 193/353.

Figure 144: Agreement that tax treatment is an advantage of the partnership



Cross-tabulation of the results also shows that the accountants who had previously advised an owner-managed business to form an ordinary partnership were significantly more likely (+32.3%) to think that it could be a tax advantageous business form.

Figure 145: Experience of advising owner-managed businesses to form an ordinary partnership, cross-tabulated with agreement that tax treatment is an advantage of the partnership



A micro-analysis of the data evidences a correlation between experience and personal view upon the tax benefits of partnerships; the greater the length of time advising, the less likely the respondent was to believe that the tax treatment of partnerships is an advantage of the form. 55%[718] of the 1-5 years and 55.1%[719] of the 6-10 years categories agreed that tax treatment is a benefit of operating through a partnership (though the latter also generated a high percentage - 10.3%[720] - of 'don't know' responses), as compared to just 41%[721] in the most experienced (more than 10 years) group.

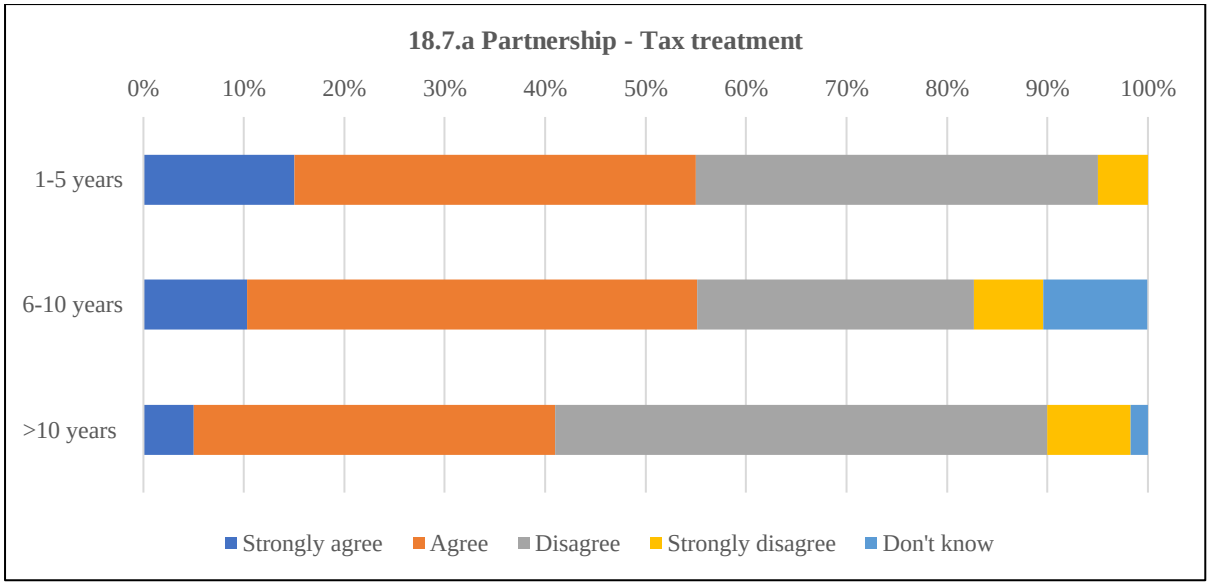
[718] 11/20.

[719] 16/29.

[720] 3/29.

[721] 123/300.

Figure 146: Agreement that tax treatment is an advantage of the partnership, by reference to experience



Prima facie, these results could lead one to query whether taxation really is influencing the decision to adopt (or not) the partnership form. In Chapter 2 (Figure 84) it was observed that the most experienced respondents (advising for more than 10 years) were the *most* likely to have advised an owner-managed business to operate as an ordinary partnership, yet the chart above demonstrates that they were also the *least* likely to see the form as tax advantageous. However, further examination of the more than 10 years category suggests that taxation-based considerations may still be affecting the advisory process; respondents in this category that had advised an owner-managed business to operate as an ordinary partnership were 29.2%[722] more likely to agree that the tax treatment of a partnership was an advantage than those who had not previously advised an owner-managed business to adopt the form (Figure 179). Put differently, respondents who viewed the partnership as tax inefficient were significantly less likely to have advised an owner-managed business to adopt the form than those who adopted the alternative

[722] 46.7% (have previously advised) as compared to 17.5% (not previously advised).

stance (that an advantage of operating as an ordinary partnership is the tax treatment). If the tax considerations were neutral in their effects upon form selection, one would expect to see these figures more closely aligned. The same trend is also identifiable within the other experience-based categories, as detailed in Figures 147-148 below.

Figure 147: Agreement that tax treatment is an advantage of the partnership, respondents in 1-5 years category, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

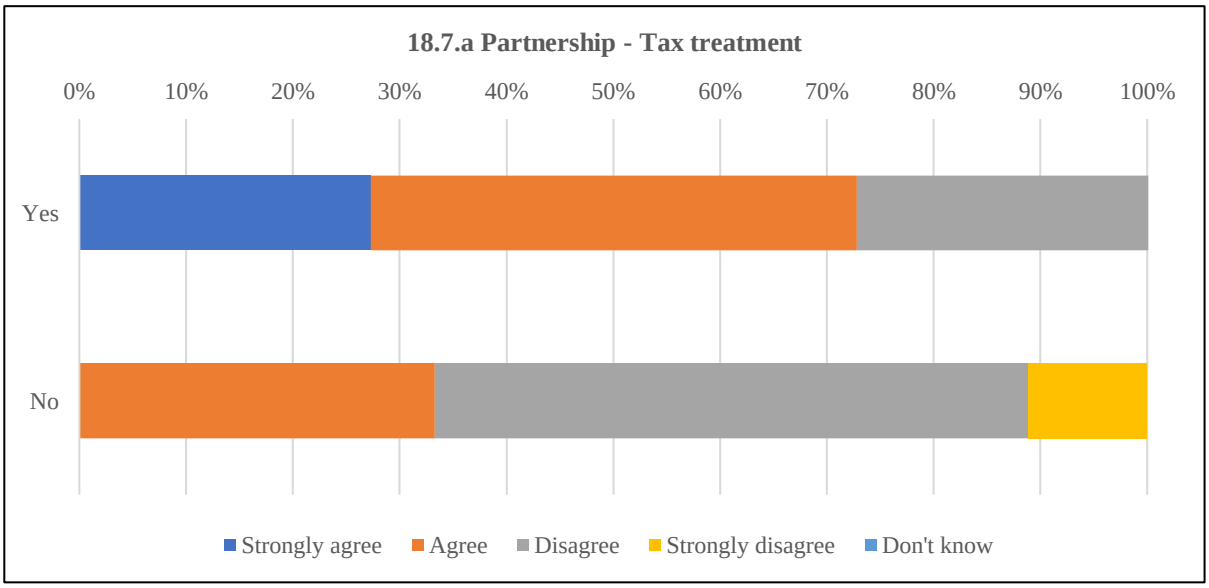


Figure 148: Agreement that tax treatment is an advantage of the partnership, respondents in 6-10 years category, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

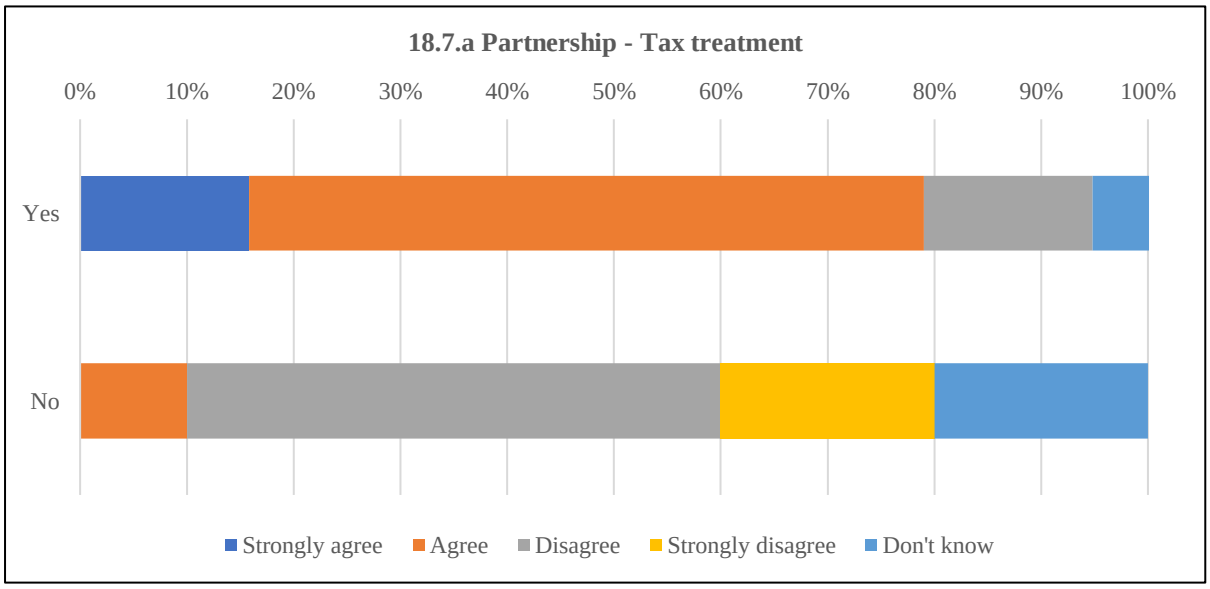
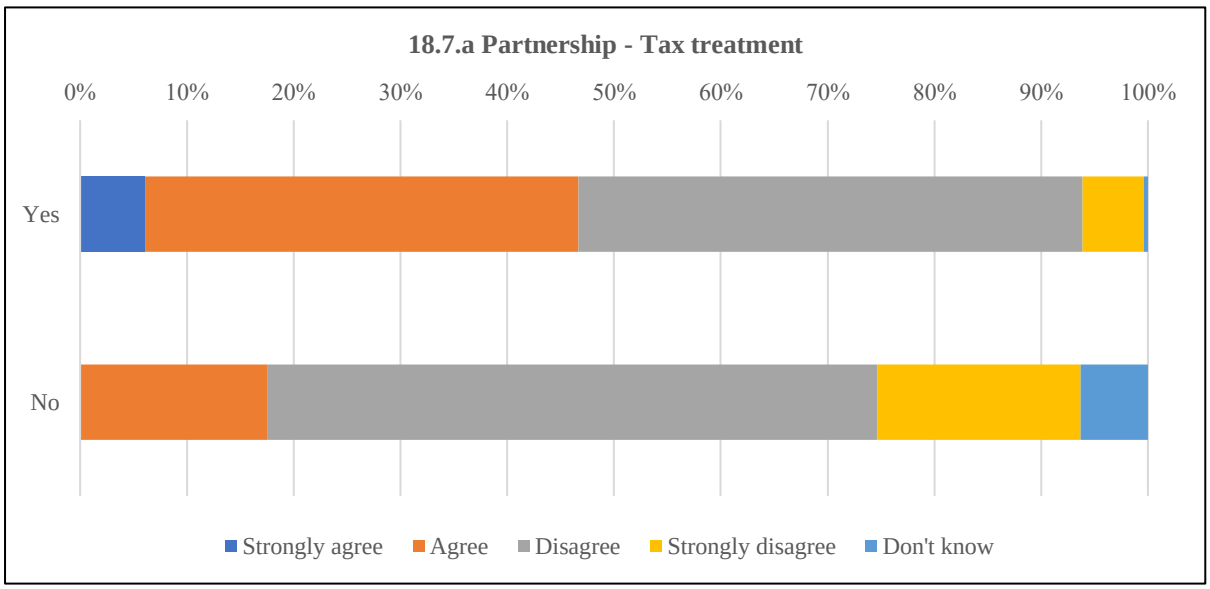


Figure 149: Agreement that tax treatment is an advantage of the partnership, respondents in >10 years category, by reference to whether have previously advised an owner-managed business to form an ordinary partnership



Differences in opinion across the categories of respondents are further evident when the data is cross-tabulated with qualification. Individuals possessing Chartered-level qualifications were the least likely to view the partnerships as a tax advantageous form (40.1%[723] of Chartered Accountants and 41.9%[724] of Chartered Tax Advisors). Their counterparts with lower-level qualifications (55%[725] AAT (or equivalent) qualified accountants and 66.7%[726] of Tax Technicians) were more positive about the tax treatment of partnerships (Figure 150). Additional scrutiny of the data produces similar results to the experience-based cross tabulation; within the qualification-based categories, those that had previously advised an owner-managed business to form an ordinary partnership were more likely to agree with the proposition that the ordinary partnership was a tax beneficial form (Figures 151-155).[727]

723 100/249.

724 13/31.

725 2/40.

726 4/6.

727 Chartered Accountants (76.9%) were the most likely to have previously advised an owner-managed business to form an ordinary partnership, followed by Chartered Tax Advisors (75%), Others (68%), AAT (or equivalent) qualified accountants (65%), and Tax Technicians (57.1%).

Figure 150: Agreement that tax treatment is an advantage of the partnership, by reference to qualification

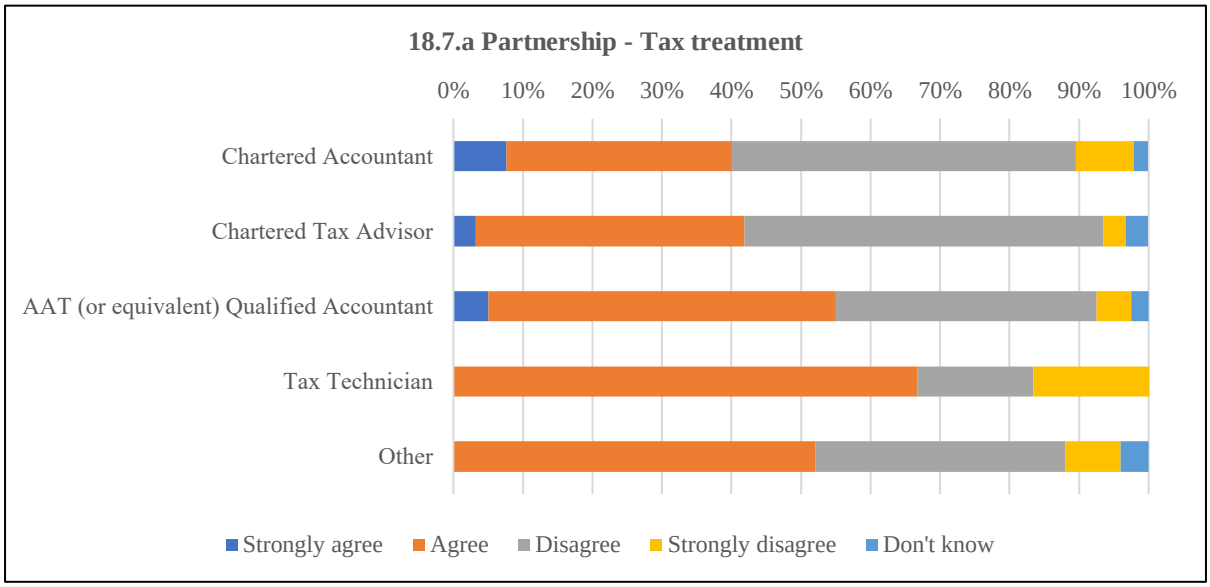


Figure 151: Agreement that tax treatment is an advantage of the partnership, Chartered Accountants, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

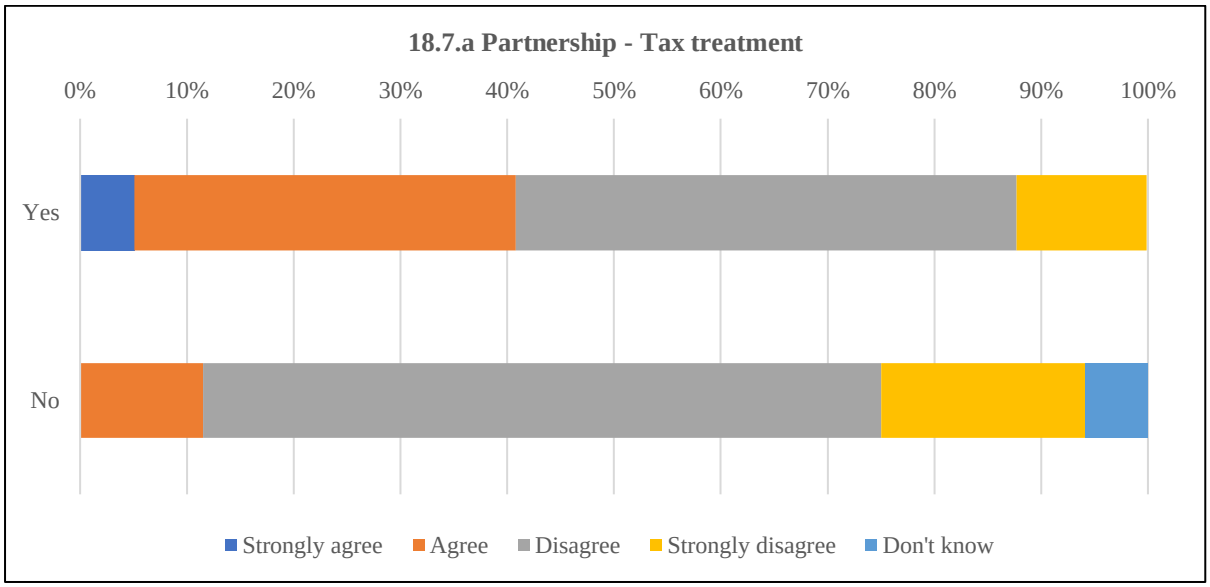


Figure 152: Agreement that tax treatment is an advantage of the partnership, Chartered Tax Advisors, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

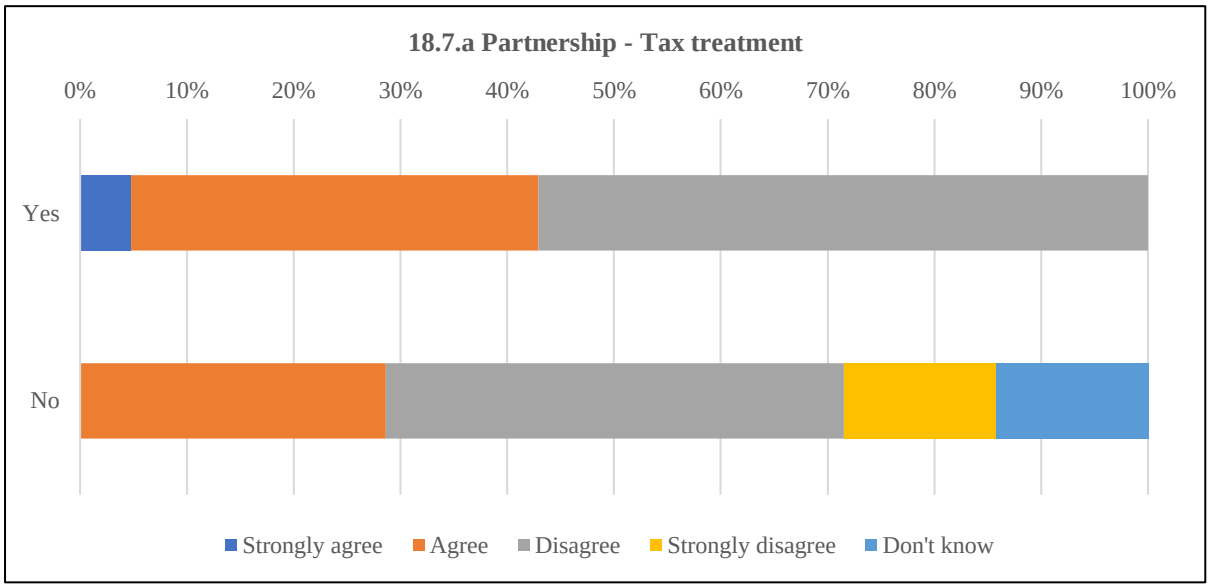


Figure 153: Agreement that tax treatment is an advantage of the partnership, AAT (or equivalent) qualified accountants, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

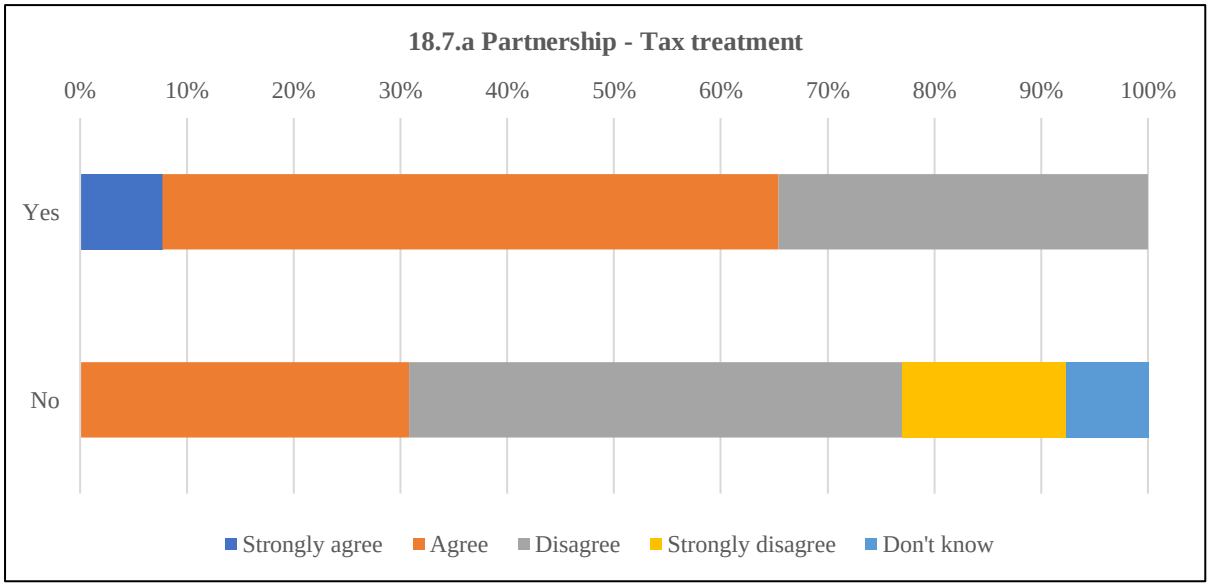


Figure 154: Agreement that tax treatment is an advantage of the partnership, Tax Technicians, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

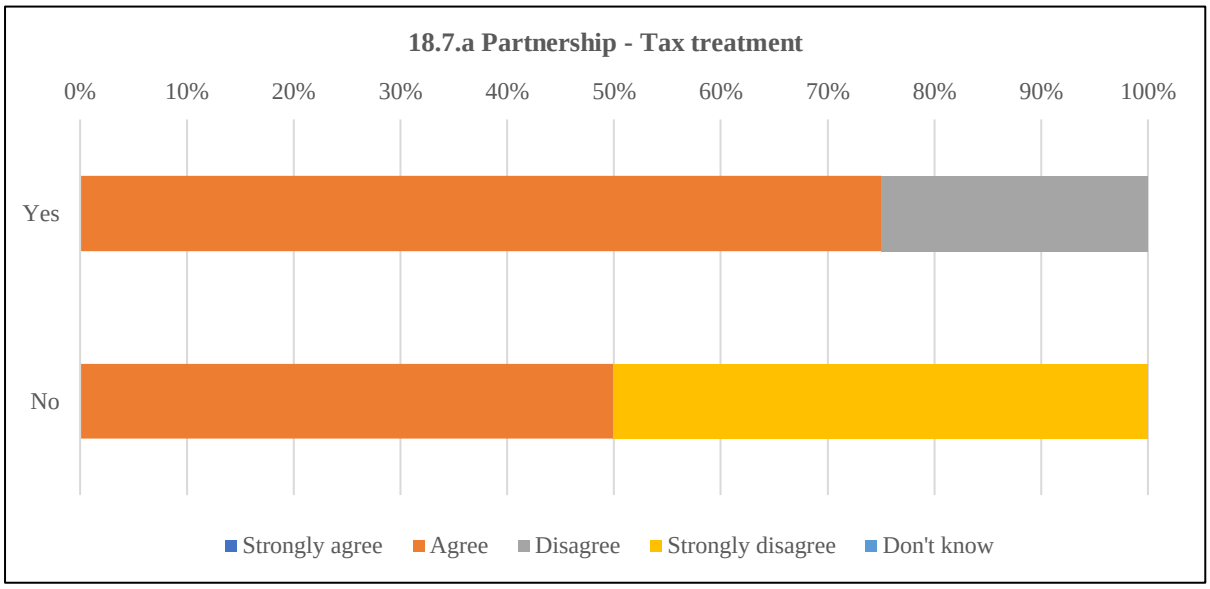
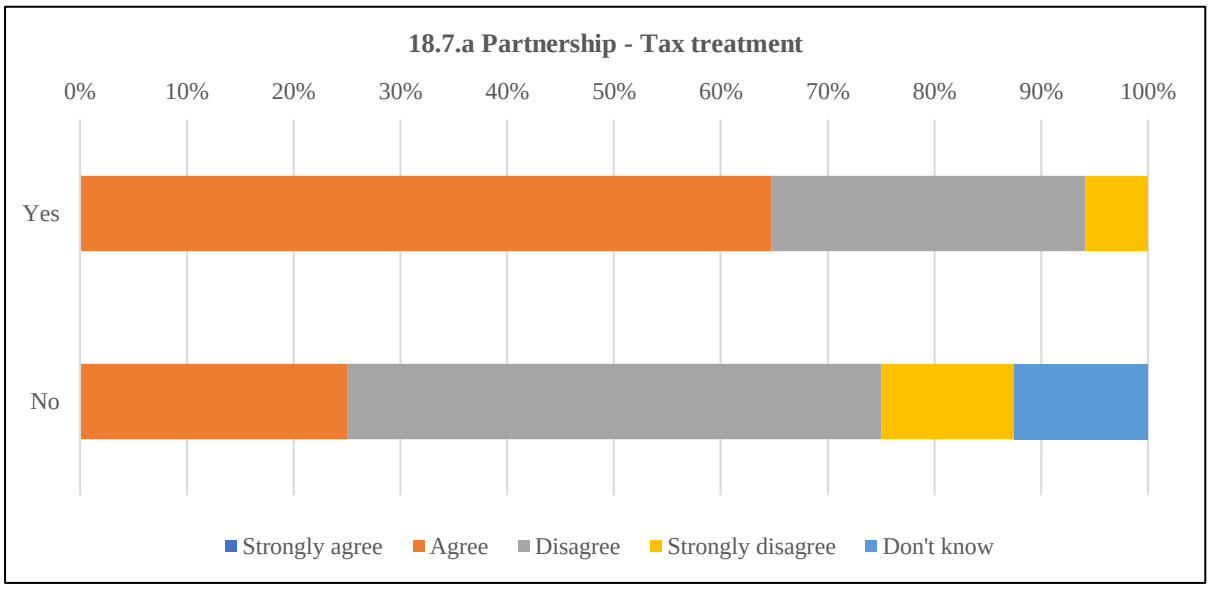


Figure 155: Agreement that tax treatment is an advantage of the partnership, Other, by reference to whether have previously advised an owner-managed business to form an ordinary partnership



Moreover, respondents based in the largest (more than 20 members) accountancy firms were most likely to agree that the tax treatment of ordinary partnerships is an advantage of the form for owner-managed businesses – 50%[728] agreed (Figure 156). However, the data does not evidence any clear relationship between firm size and views upon the tax treatment of partnerships; the lowest level of agreement with the proposition stemmed from accountants in firm sizes of 11-20 (30.7%).[729] Unusually, the more than 20 members category had a greater percentage of respondents that had not previously advised an owner-managed business to form a partnership agreeing with the proposition that tax treatment was an advantage, as compared to those who had advised owner-managed businesses to do so (Figure 160). This anomaly may simply be due to the fact that only two respondents in this group had not previously advised an owner-managed business to form a partnership (28 had) so the results are heavily skewed in this respect. The other categories produced results consistent with cross-tabulations for experience and qualification; those who had previously advised an owner-managed business to form an ordinary partnership were more positive about the tax position (Figures 156-159).

728 21/42.

729 12/39.

Figure 156: Agreement that tax treatment is an advantage of the partnership, by reference to firm size

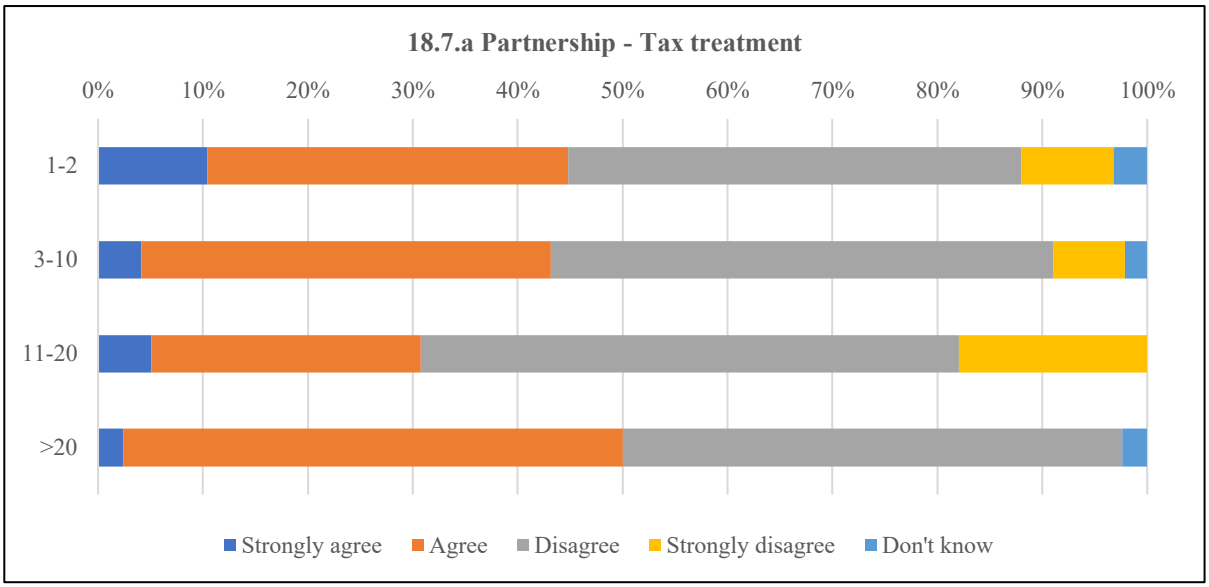


Figure 157: Agreement that tax treatment is an advantage of the partnership, firm size 1-2, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

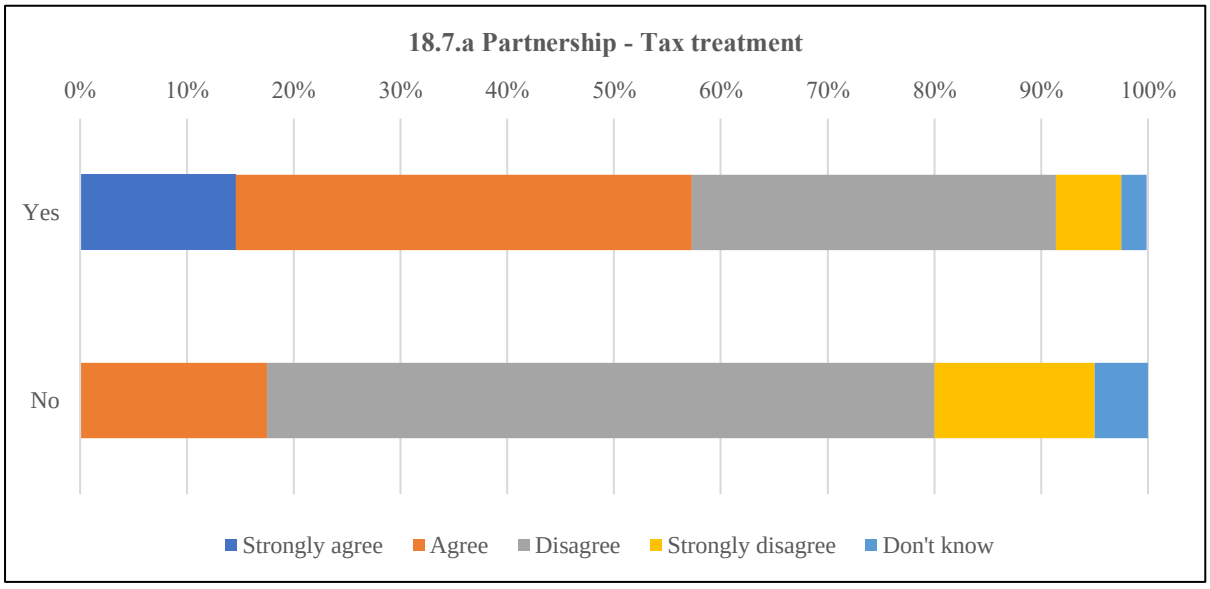


Figure 158: Agreement that tax treatment is an advantage of the partnership, firm size 3-10, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

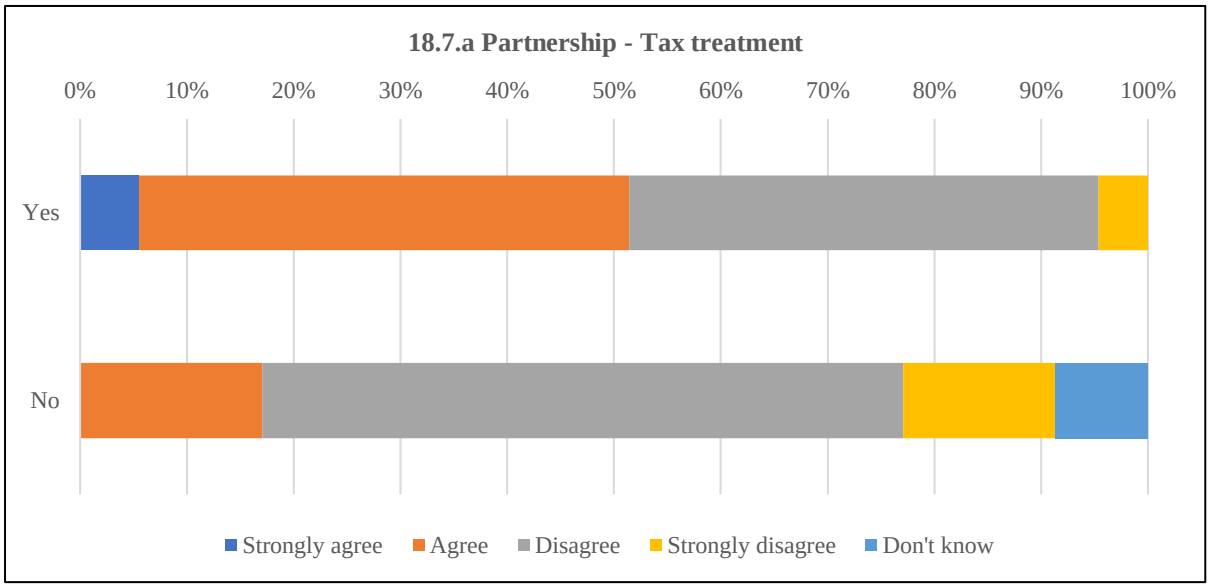


Figure 159: Agreement that tax treatment is an advantage of the partnership, firm size 11-20, by reference to whether have previously advised an owner-managed business to form an ordinary partnership

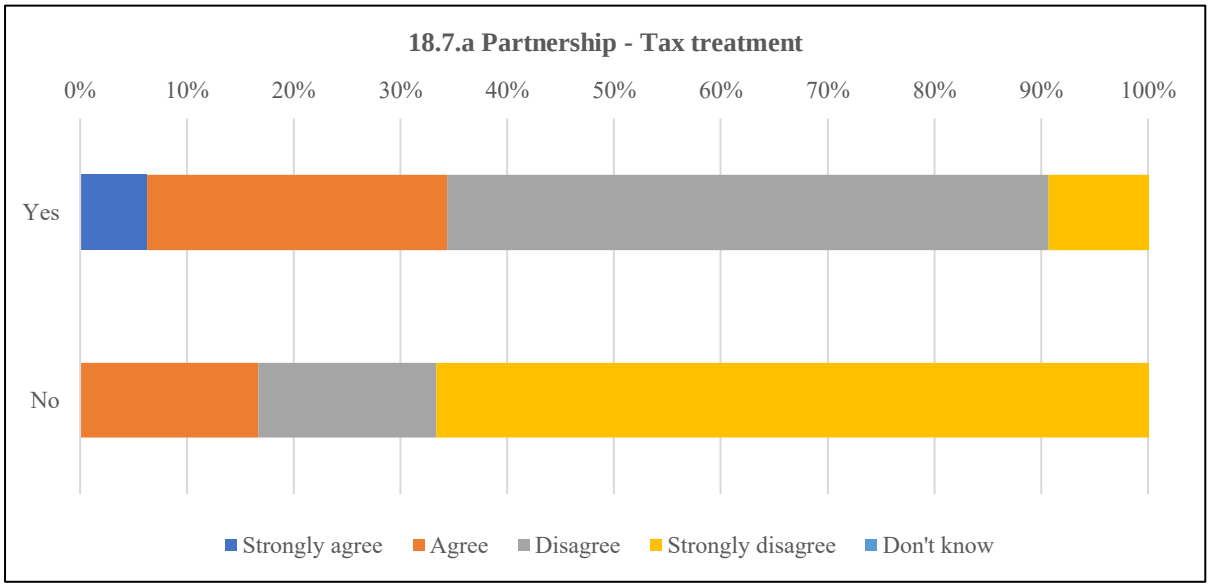
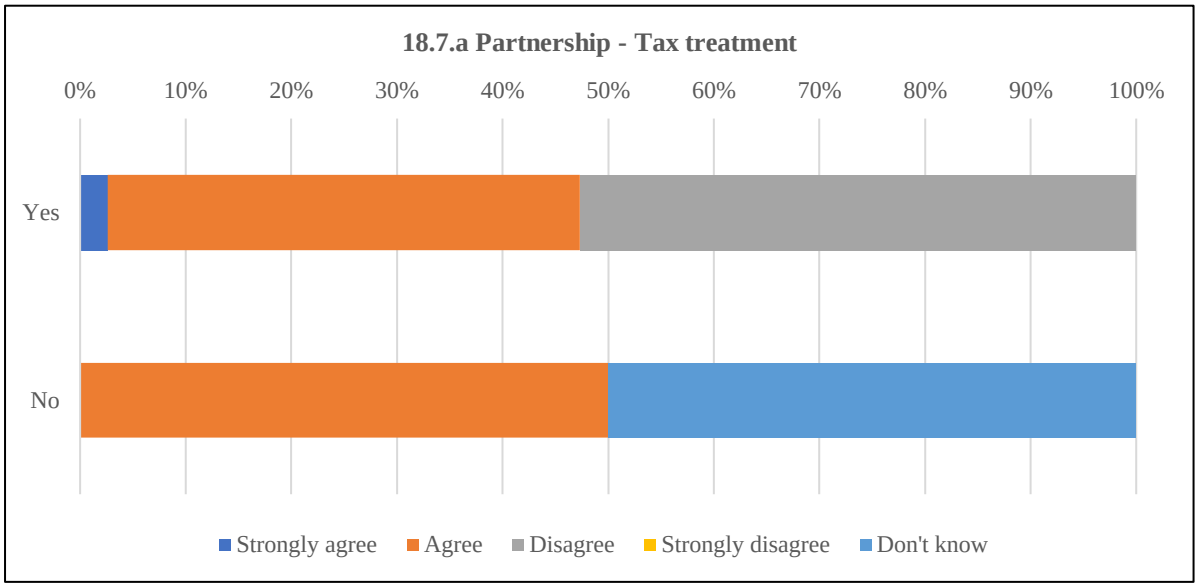


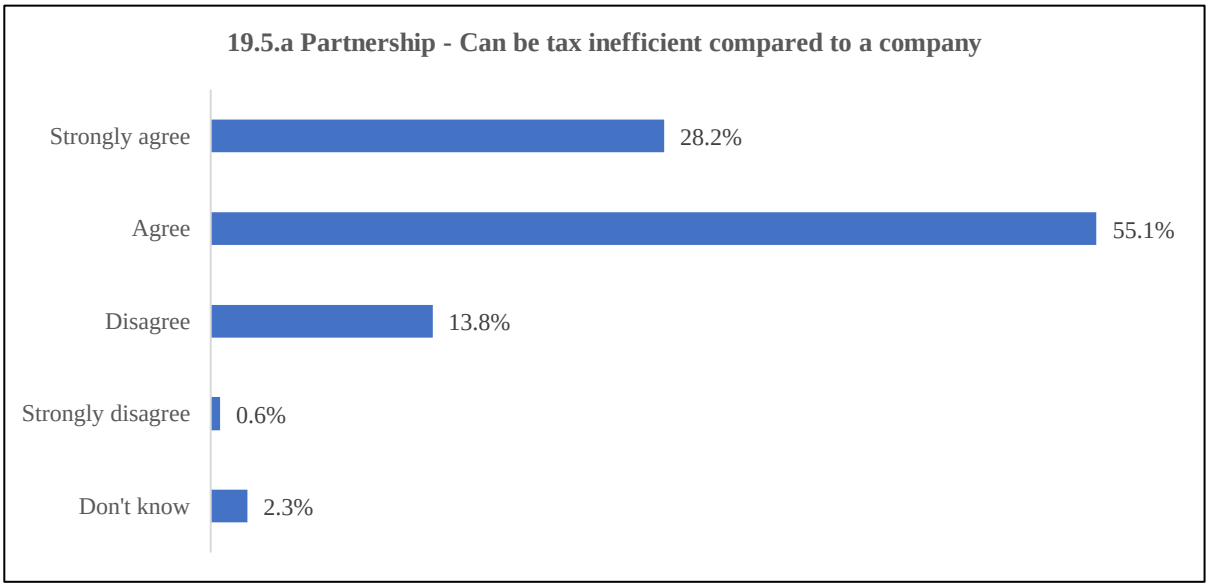
Figure 160: Agreement that tax treatment is an advantage of the partnership, firm size >20, by reference to whether have previously advised an owner-managed business to form an ordinary partnership



As previously indicated, variations in individual circumstances and income (particularly loss) levels will sometimes mean that the partnership is, in some cases, the more tax efficient form, which has almost certainly factored into the decision of a number of respondents to agree that the tax treatment of the ordinary partnership can be beneficial (see Part 4.5.1.4). There are also income splitting opportunities to take into account (see Part 4.6). In order to provide a more direct comparison between the tax treatment of companies and partnerships, the respondents, after considering the partnership in isolation, were subsequently asked the extent to which they agreed with the statement that one disadvantage of operating through a partnership (as an owner-managed business) is that it could be tax inefficient when

compared to a company.[730] On this question, 83.3%[731] agreed that the partnership could be relatively tax inefficient; a significant proportion (28.2%)[732] were confident enough to strongly agree.

Figure 161: Agreement that tax treatment relative to a company is a disadvantage of the partnership



Respondents who stated that they had previously advised an owner-managed business to form an ordinary partnership were in fact marginally more likely to agree (+4.5%),[733] though less likely to strongly agree,[734] that the tax treatment of partnerships could be disadvantageous

730 The HMRC Reasons Behind Incorporation (n 25) 51, reported that 39% of their respondents that had converted from a partnership to a company thought that tax and NI savings were a benefit of the form. This was higher than the other categories of respondents (new incorporations and incorporation following sole-trading).

731 295/354.

732 100/354.

733 84.3% (222/262) as compared to 79.8% (67/84).

734 25.6% (68/222) as compared to 36.9% (31/84).

as compared to a company than those who had not. They were also slightly more likely to disagree with the proposition that the ordinary partnerships were tax inefficient compared to a company (+1.4%) (Figure 162). This disparity is accounted for in the relatively high proportion of 'don't know' responses (7.1%)[735] generated by the accountants who had not previously advised an owner-managed business to form an ordinary partnership – none of those who had advised the use of a partnership provided a 'don't know' response.[736] It is reasonable to expect that those who have experience of advising owner-managed businesses to form partnerships would find it easier to express a firm view on the relative taxation benefits of doing so. The overall position appears to be that whilst having previously advised an owner-managed business to form an ordinary partnership correlates with an increased likelihood of adopting the view that they can be tax advantageous, this experience does not entail that the partnership will be viewed as tax advantageous when *compared to* a company; indeed, chances are they will not. The overwhelming stance of the respondents is that the partnership is generally the more tax inefficient form of the two. This conclusion is also supported by the cross-tabulation results for qualifications (Figure 163), experience (Figure 164), and firm size (Figure 165). Even those categories that were generally positive about the tax treatment of the partnership in isolation (e.g. Tax Technicians), adopted a relatively firm view that in comparison to a company, the form is tax inefficient for owner-managed businesses.

735 6/84.

736 Though excluded from the above calculations, 7.7% of those who answered 'no' to the Question 17 ('Have you ever advised an owner-managed business to form an ordinary partnership?') chose not to answer Question 19.5.a (partnerships can be tax inefficient compared to a company).

Figure 162: Experience of advising an owner-managed business to form an ordinary partnership, cross-tabulated with agreement that tax treatment relative to a company is a disadvantage of the partnership

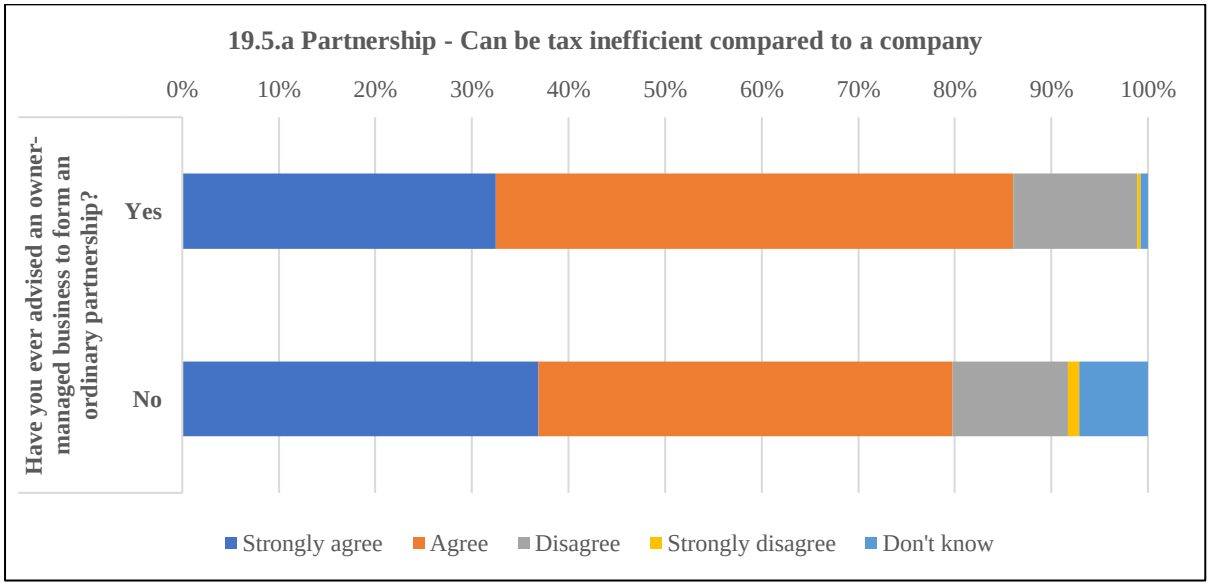


Figure 163: Agreement that tax treatment relative to a company is a disadvantage of the partnership, by reference to qualification

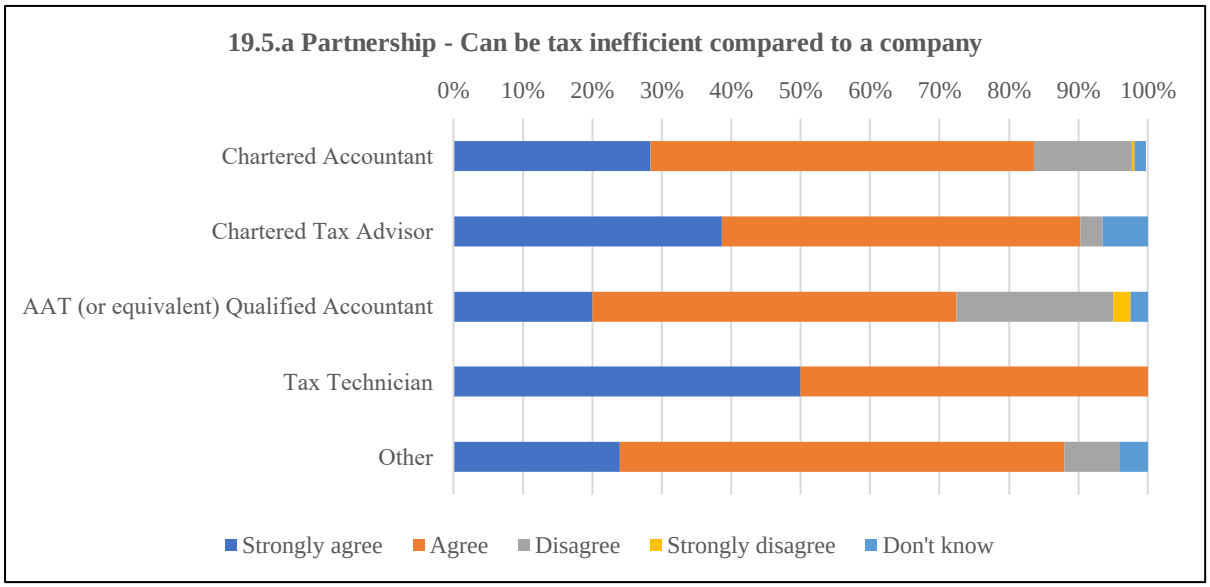


Figure 164: Agreement that tax treatment relative to a company is a disadvantage of the partnership, by reference to experience

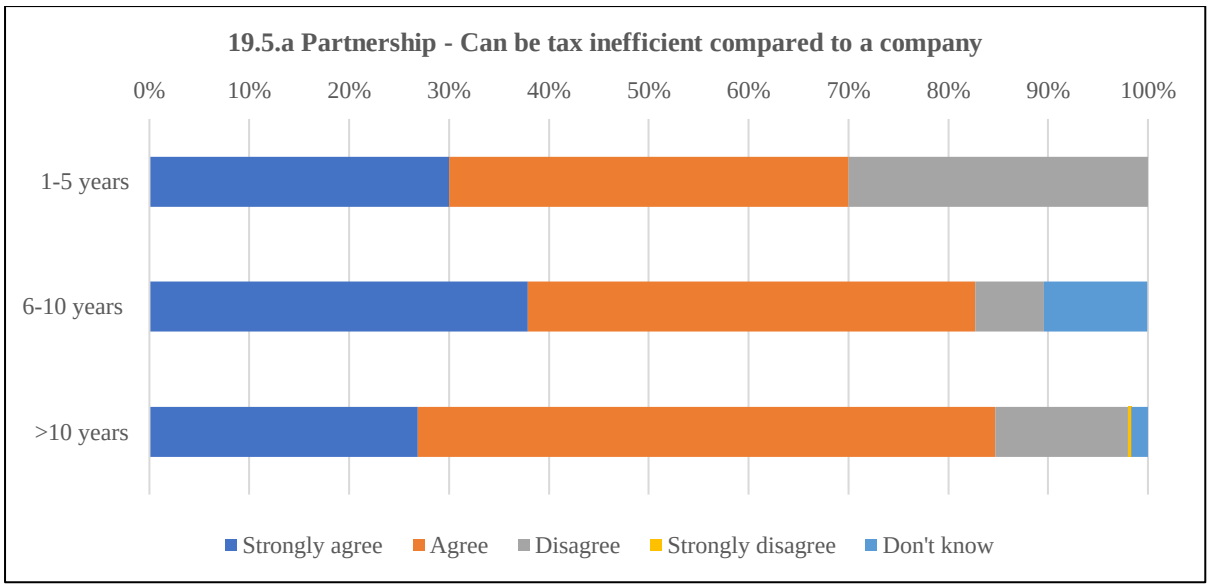
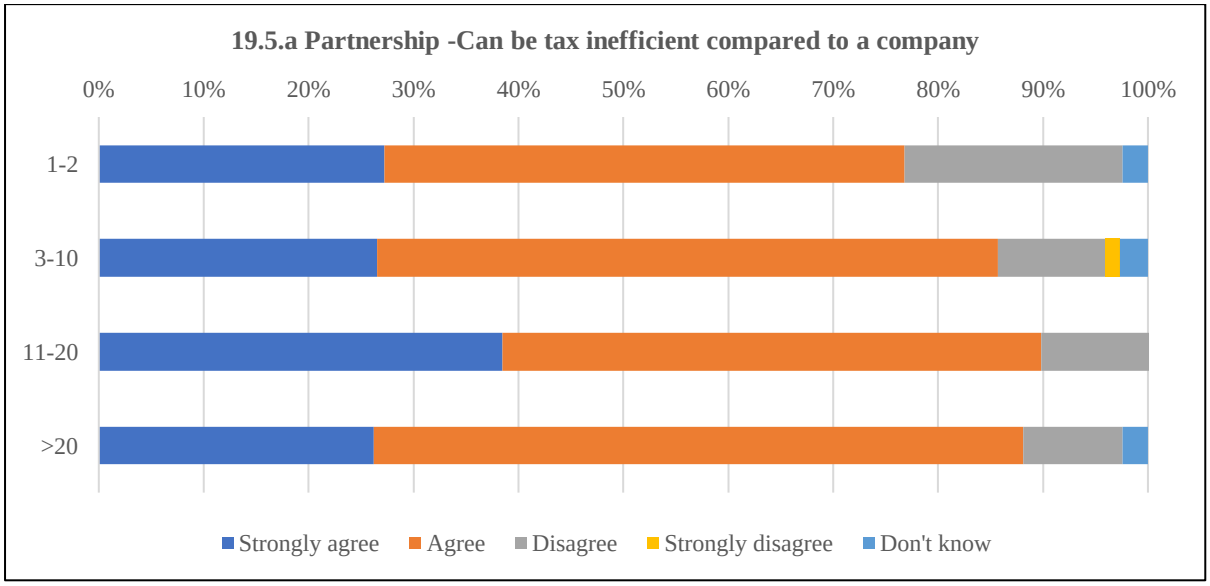


Figure 165: Agreement that tax treatment relative to a company is a disadvantage of the partnership, by reference to firm size



So long as the members are unaffected by anti-avoidance provisions, LLP members are taxed in the same way as partners in an ordinary partnership.[737] Accordingly, there was no strict need to deal with the taxation of LLPs on a separate basis in the survey. However, in the interests of acquiring a more complete picture in relation to taxation matters, the survey (as with ordinary partnerships) queried whether the tax treatment of the LLP was an advantage of the form and whether it was considered as tax inefficient as compared to a company for owner-managers. The respondents were presented with the same questions as in the partnerships section of the survey; consideration of the LLP tax treatment in isolation, and tax treatment relative to the company.

When prompted to consider whether the tax treatment is an advantage of the LLP, the majority of respondents (55.3%)[738] to the initial survey version agreed. This is 12.3% higher than the percentage of respondents[739] that agreed that the tax treatment of the ordinary partnership is an advantage of the form, and 21.6%[740] lower than the percentage of respondents who disagreed with the proposition in relation to ordinary partnerships. The increased positivity may be due to the use of corporate partners in some LLP structures,[741] though this would be too complex to operate for the majority of owner-managers, and almost certainly inappropriate in non-professional sectors.[742] A high level of 'don't know' responses (11.7%)[743]

737 ITTOIA 2005, s 863; Corporation Tax Act 2009 ("**CTA 2009**"), s 1273.

738 174/315.

739 43% (partnerships) as compared to 55.3% (LLPs).

740 54.6% (partnerships) as compared to 33% (LLPs).

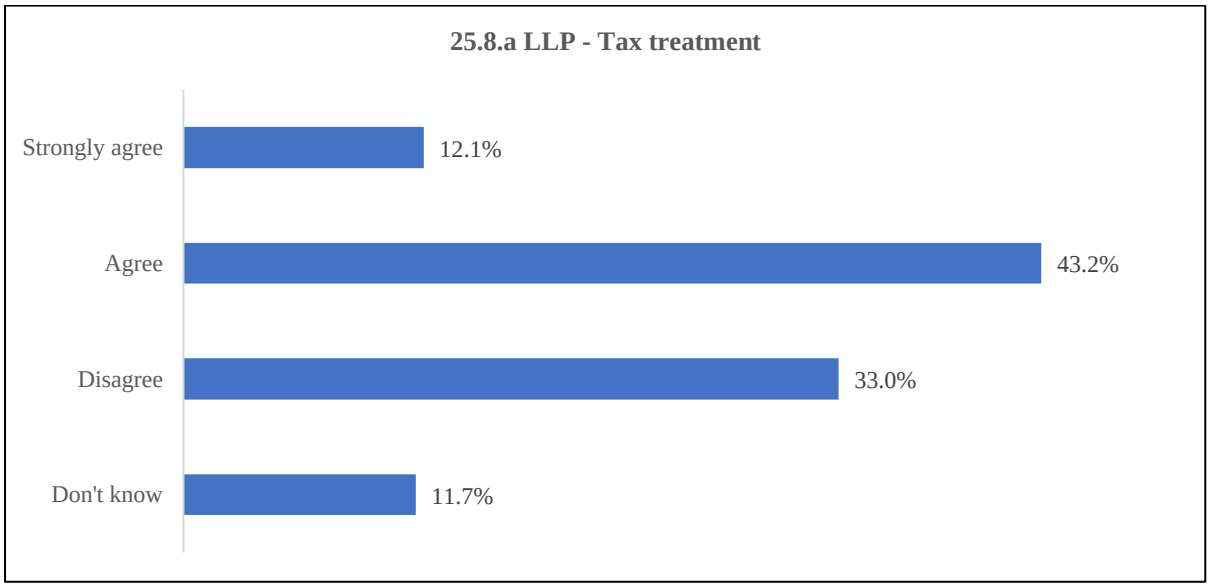
741 One respondent referred to the use of corporate members for tax efficiency in the free-text response option.

742 Strictly speaking, nothing would prevent the use of a corporate partner in an ordinary partnership, but this does not appear to be common practice.

743 37/315.

were received on this point; perhaps another indication that the LLP is less well understood than ordinary partnerships and companies.

Figure 166: Agreement that tax treatment is an advantage of the LLP

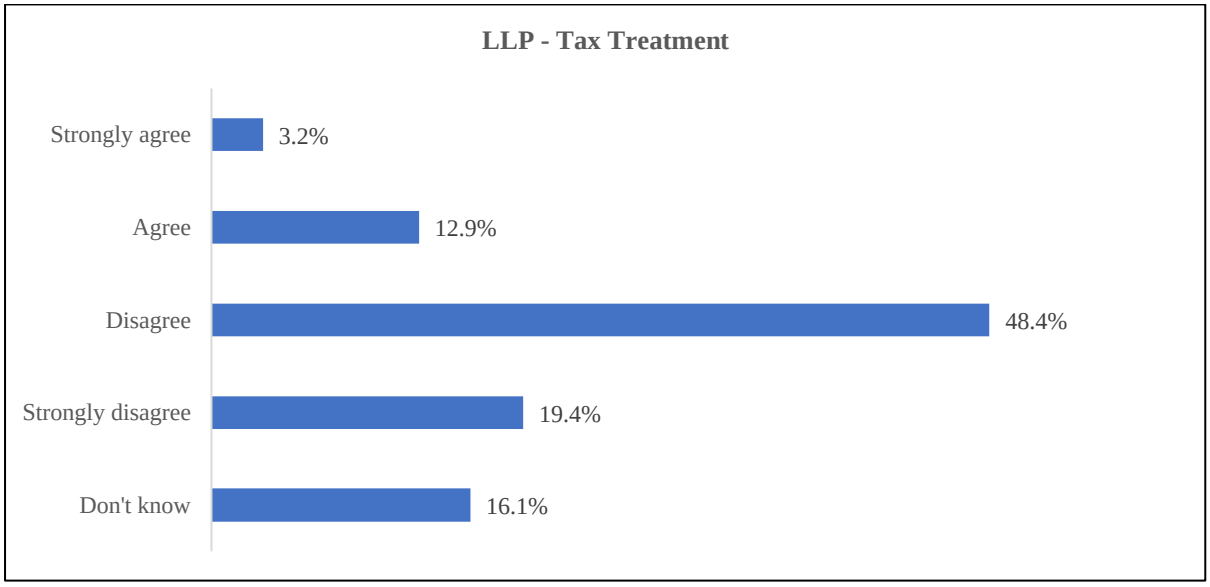


Interestingly, the position was overwhelmingly negative on the corrective survey, whereby only 16.1%[744] of the respondents agreed that the taxation of the LLP was advantageous for owner-managed businesses (an equal – and slightly higher than the original survey – amount of respondents selected the 'don't know' option) (Figure 167). The 39.2% differential is significantly higher than any of the commercial considerations discussed in Chapter 3. There are two potential conclusions that can be drawn here. Firstly, it may be the case that the incorrect phrasing of the LLP advantages question did skew the overall results, which becomes most evident in relation to the taxation matter (also likely to be the most controversial). Secondly, and alternatively, it may simply be a coincidence that the second survey respondents were less impressed by the tax position of the LLP than the full sample

744 5/31.

initially received, and that the latter should be taken as representative based on the larger number of respondents. Given that this cannot be conclusively determined, the remainder of this section proceeds on the basis of the assumption that the latter is true, which thereby facilitates full presentation of the original results. That being said, there is a strong cautionary note attached.

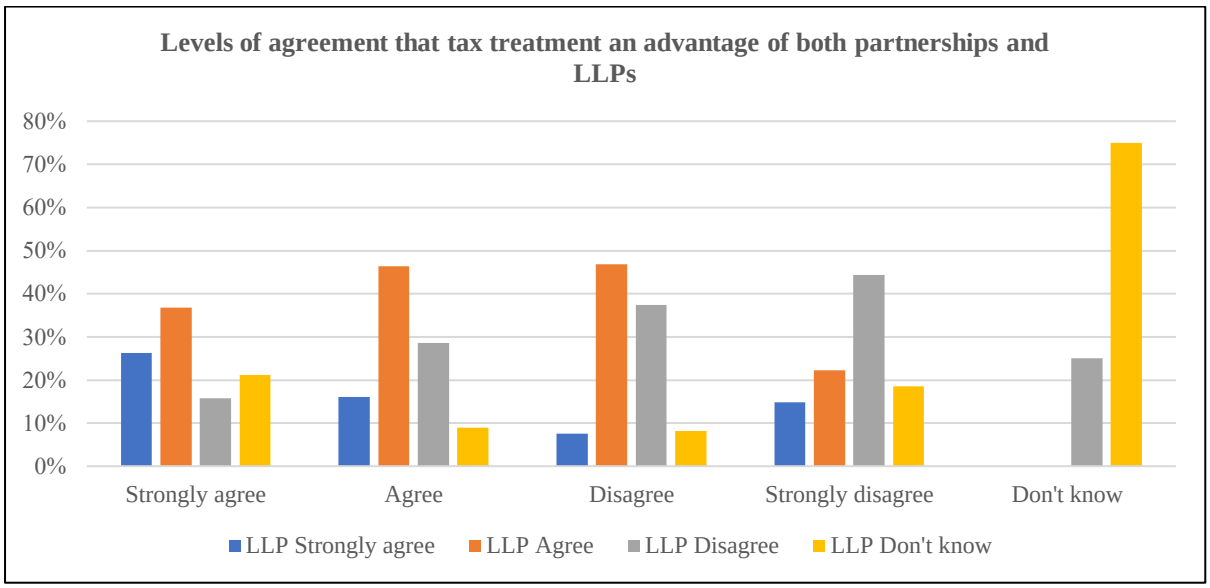
Figure 167: Agreement that tax treatment is an advantage of the LLP (v2)



Investigation of the consistency between responses to the taxation of ordinary partnerships and LLPs (on the basis of the original survey) reveals that, as a general rule, those who viewed the taxation treatment of ordinary partnerships positively, were also more likely to report that the taxation treatment of LLPs was an advantage of the form. Likewise, individuals disagreeing with the proposition that the tax treatment was an advantage of the ordinary partnership, were more likely to also disagree with the proposition when applied to LLPs. However, the correlation is not as clear as might have been expected, particularly with regard to the respondents that disagreed with the proposition that the partnership tax treatment

is an advantage of the form (54.4%[745] agreed that the LLP tax treatment is an advantage of the form), reflecting the overall more positive stance to LLP tax treatment. Given the equality in tax treatment between the two forms this result is, in some measure, anomalous.

Figure 168: Agreement that tax treatment is an advantage of the LLP, cross-tabulated with agreement that tax treatment is an advantage of the ordinary partnership



Once again, individuals that had previously advised an owner-managed business to form an LLP were significantly more positive about the tax treatment of the form when compared to those who had not – 69%[746] as opposed to 43.8%.[747] 20.2%[748] 'don't know' responses were received from those who had not previously advised the use of an LLP. Herein

745 80/147.

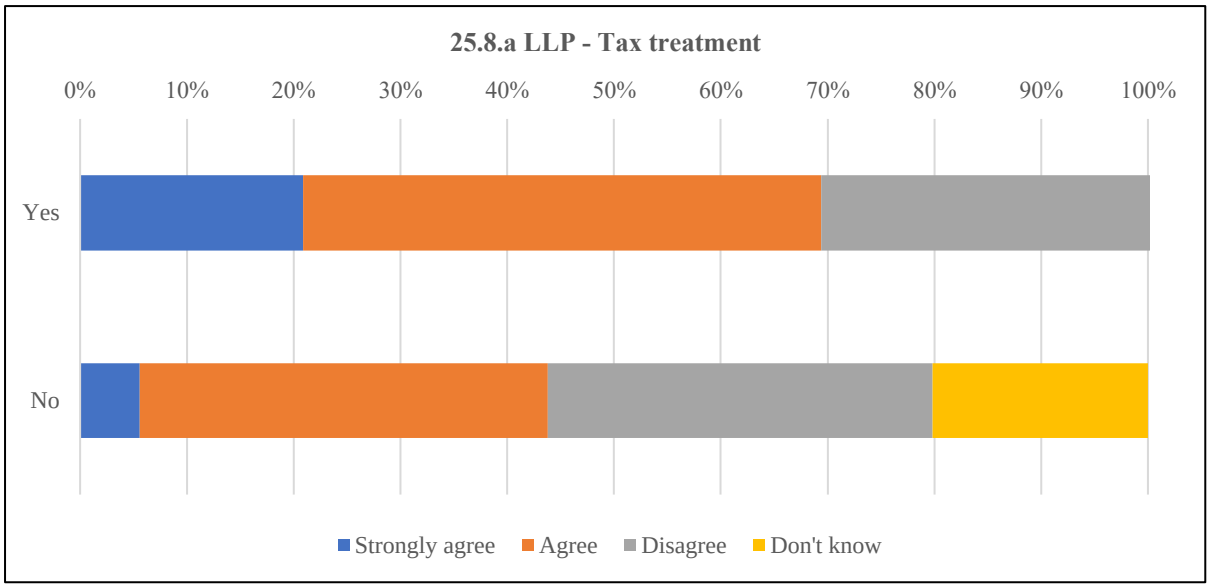
746 93/134.

747 78/178. 43 respondents who had not previously advised an owner-managed business to form an LLP declined to answer the question (19.5%).

748 36/178.

lies another indication that tax-based considerations may be influencing the advisory process in relation to the choice of business form.

Figure 169: Experience of advising owner-managed businesses to form an LLP, cross-tabulated with agreement that tax treatment is an advantage of the LLP



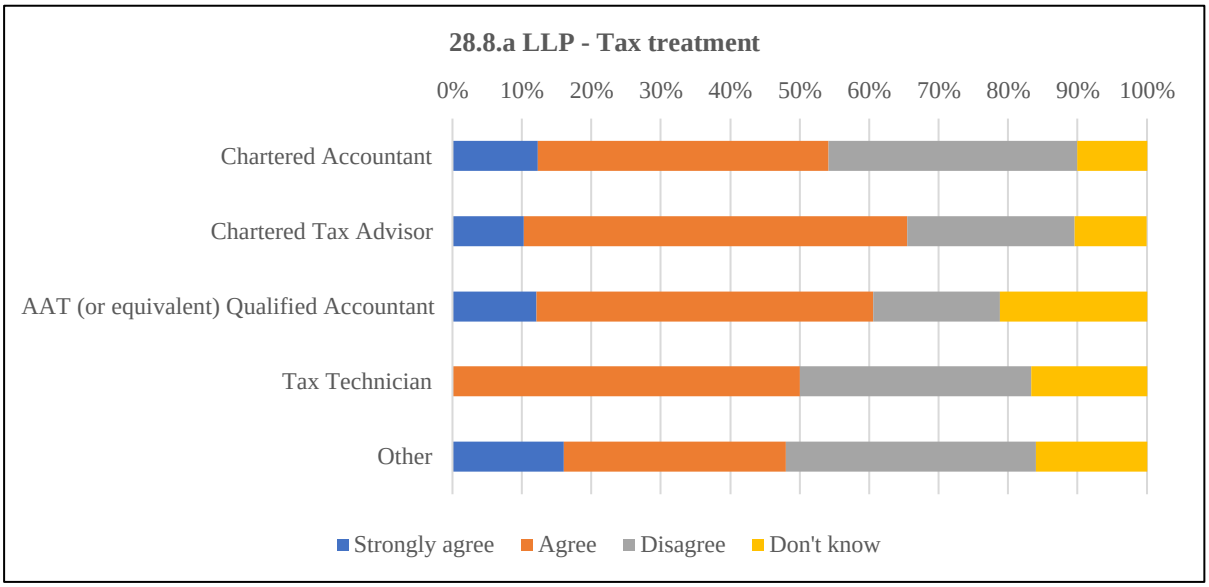
By way of contrast to the ordinary partnership data, respondents possessing Chartered-level qualifications were much more likely to agree with the proposition that the tax treatment of the LLP was advantageous (+14%[749] Chartered Accountants; +10.5%[750] Chartered Tax Advisor); in respect of partnerships, these respondents were least likely to view the tax treatment in a positive light. On the other hand, the remaining categories recorded higher percentages – in terms of level of agreement that tax treatment was an advantage of the form(s)

749 54.1% (LLPs) as compared to 40.1% (partnerships).

750 65.5% (LLPs) as compared to 41.9% (partnerships).

for partnerships than for LLPs, (-16.1%[751] AAT (or equivalent) qualified; -2%[752] Tax Technician; -4% Other).

Figure 170: Agreement that tax treatment is an advantage of the LLP, by reference to qualification



As was the case with ordinary partnerships, cross-tabulation of the LLP data with the respondents' length of time advising demonstrated that the least experienced were most positive about the tax treatment of the LLP as compared to their more experienced counterparts: 72.3%[753] of respondents in the 1–5-year category agreed that tax treatment is an advantage of the LLP for owner-managed business. The figures for the 6-10 year and more than 10 years

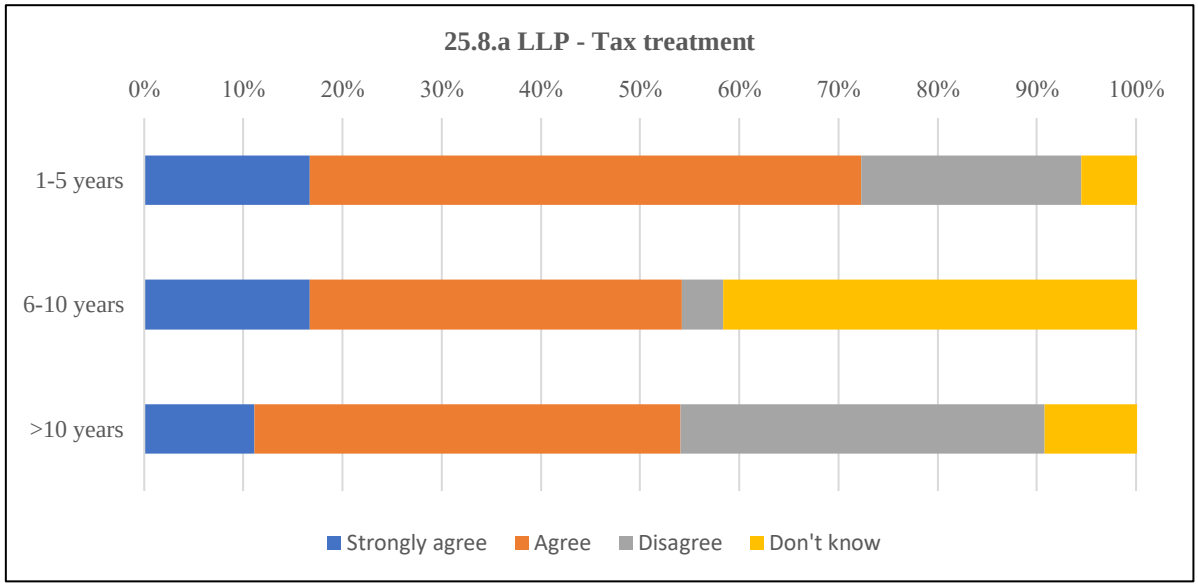
751 60.6% (LLPs) as compared to 66.7% (partnerships).

752 50% (LLPs) as compared to 52% (partnerships).

753 13/18.

categories are 54.2%[754] and 54.1%[755] respectively, though the former also contains an extremely high (41.7%)[756] number of 'don't know' responses.

Figure 171: Agreement that tax treatment is an advantage of the LLP, by reference to experience



As discussed in Chapter 3, the more than 10 years group were also most likely to have advised an owner-managed business to form an LLP in the past. Accordingly, and with a view to testing the neutrality of the tax consideration, the above results to this taxation question were further cross-tabulated with whether the respondent had previously advised an owner-managed business to form an LLP. Only 4 responses were available for cross-tabulation in the 1-5 years category. Only 5 were available in the 6-10 years class. No reliable data can therefore be extracted from these groups, but in the more than 10 years group, respondents who had

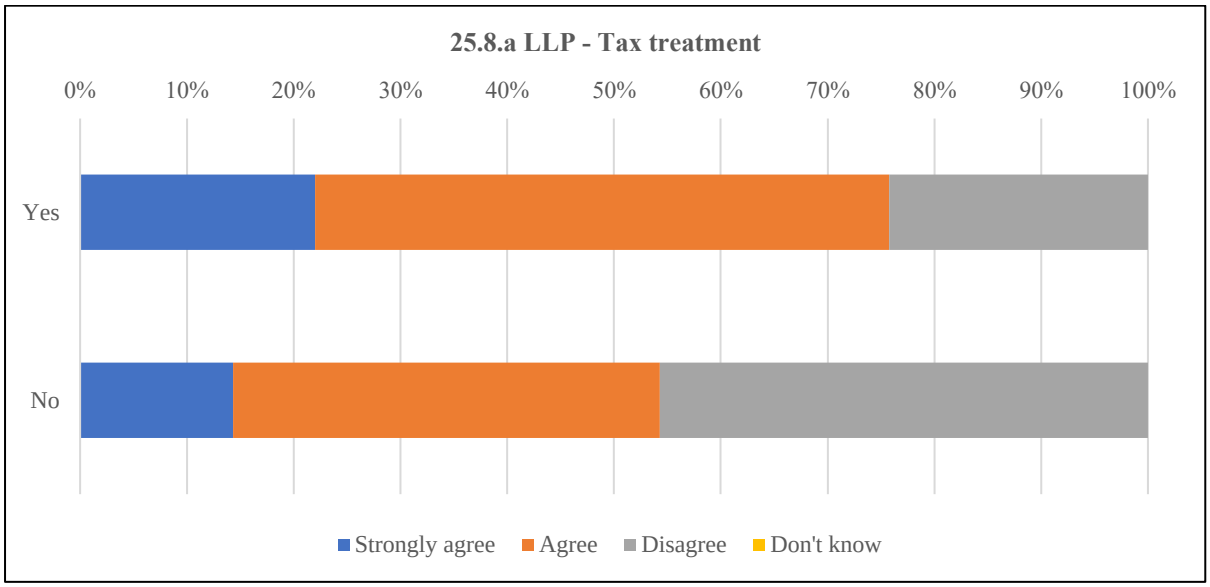
754 13/24.

755 146/270.

756 10/24.

previously advised the use of an LLP to an owner-managed business were 21.5% more likely to view the tax treatment of an LLP as an advantage of the form.[757]

Figure 172: Experience of advising an owner-managed business to form an LLP, respondents in >10 years category, cross-tabulated with agreement that tax treatment is an advantage of the LLP



Cross-tabulation of the data on the basis of firm size shows very similar levels of agreement with the proposition that the LLP is tax advantageous in the 1-2 (52.2%),[758] 3-10 (55.5%)[759] and 11-20 (52.5%)[760] firm size categories, but there is also a noteworthy increase in the percentage attributable to respondents based in the largest firms (more than 20 – 64.1%).[761] Across all size-based groups, a greater percentage of respondents were inclined to

[757] 75.8% (yes) as compared to 54.3% (no).

[758] 58/111.

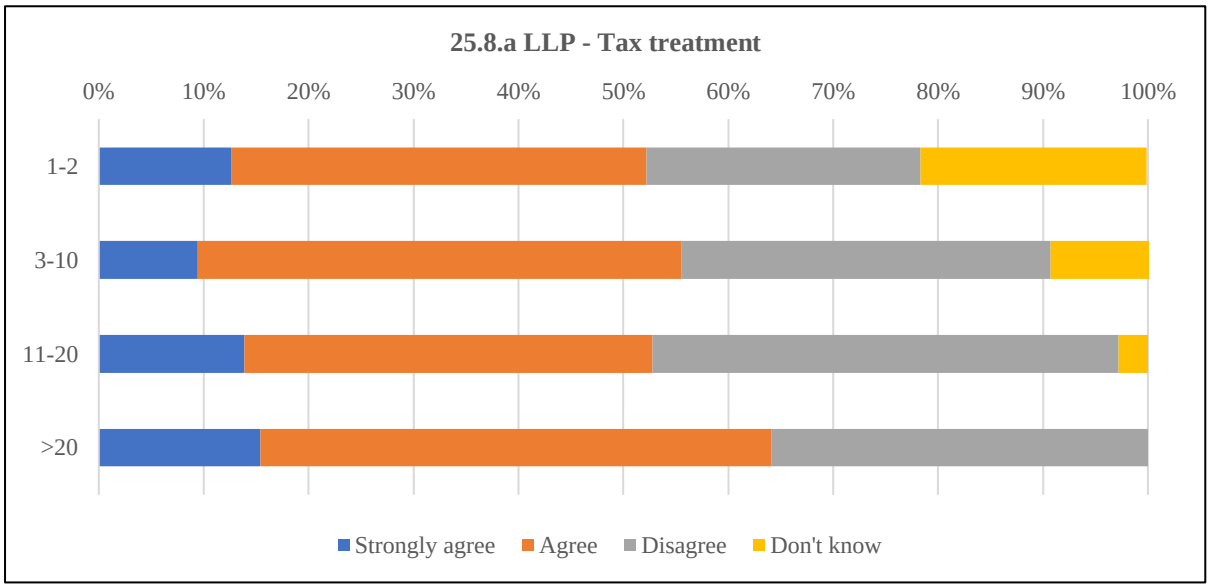
[759] 71/128.

[760] 19/36.

[761] 25/39.

agree with the proposition that the tax treatment of the LLP is a benefit of the form than was the case for partnerships.[762]

Figure 173: Agreement that tax treatment is an advantage of the LLP, by reference to firm size



In light of the overall more favourable position of the respondents in relation to the tax treatment of the LLP (relative to the company), it might be argued that if tax had a significant influence on the selection of form, then the LLP should have had more success with small businesses than the evidence suggests.[763] To this, there are two responses. Firstly, as discussed in previous Chapters, limited liability is touted as a major attraction for owner-managers yet even this offer did not suffice to tempt owner-managed businesses to adopt the LLP. There is no reason to expect taxation to do so either; the complexity of the LLP seemingly undercuts its potential privileges. Secondly, the tax position relative to the company also needs addressing.

762 +7.5% (1-2); +12.4% (3-10); +22.1% (11-20); +14.1% (>20).

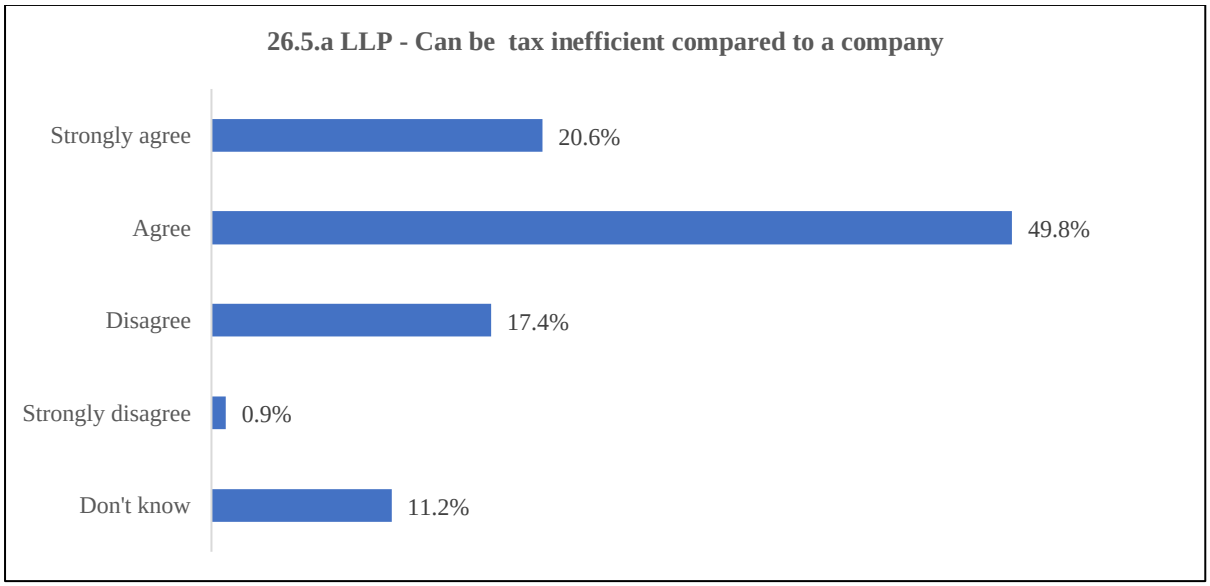
763 See Chapter 3.

Commenting on the LLP in 2010, Crawford and Freedman were sceptical as to the LLPs tax position:[764]

> [t]here has been some speculation that they [LLPs] might be utilized by small traders but they have not yet become popular for this purpose, not being designed with this in mind, and because, to date, they have not been attractive to most ordinary small businesses from a tax point of view. If the benefits of incorporation were to be eroded by higher corporation tax rates for small companies, this could change.

In this respect, the survey results also evidence a perception that, just as with the ordinary partnership, the LLP is tax inefficient as compared to a company – 70.4%[765] agreed that this was a disadvantage of operating as an LLP (the partnership figure was higher at 83.3% which is consistent with the above results indicating a more favourable view of the LLP).

Figure 174: Agreement that tax treatment relative to a company is a disadvantage of the LLP

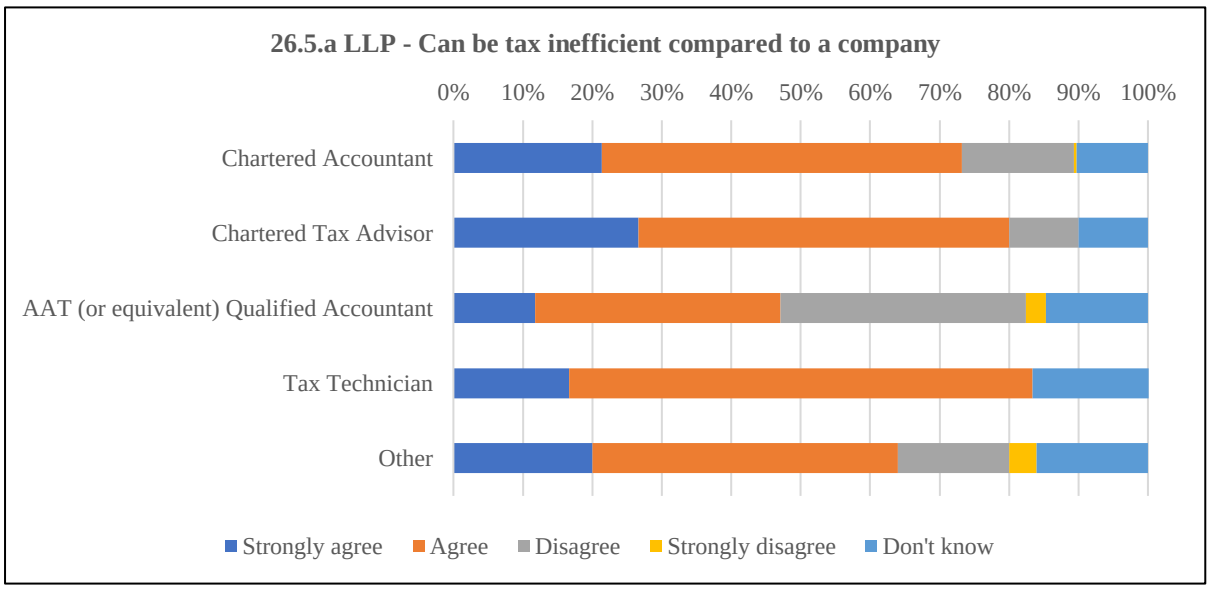


764 Mirrlees (n 661) 1042.

765 226/321.

Variations in the data were identified across the different qualification groups, but there is no clear correlation between level of qualification and views upon the proposition that the LLP can be tax inefficient compared to a company; the highest recorded percentage (83.4%)[766] is with the Tax Technician group,[767] but the lowest (47.1%) is with the similarly qualified AAT (or equivalent) accountants.

Figure 175: Agreement that tax treatment relative to a company is a disadvantage of the LLP, by reference to qualification



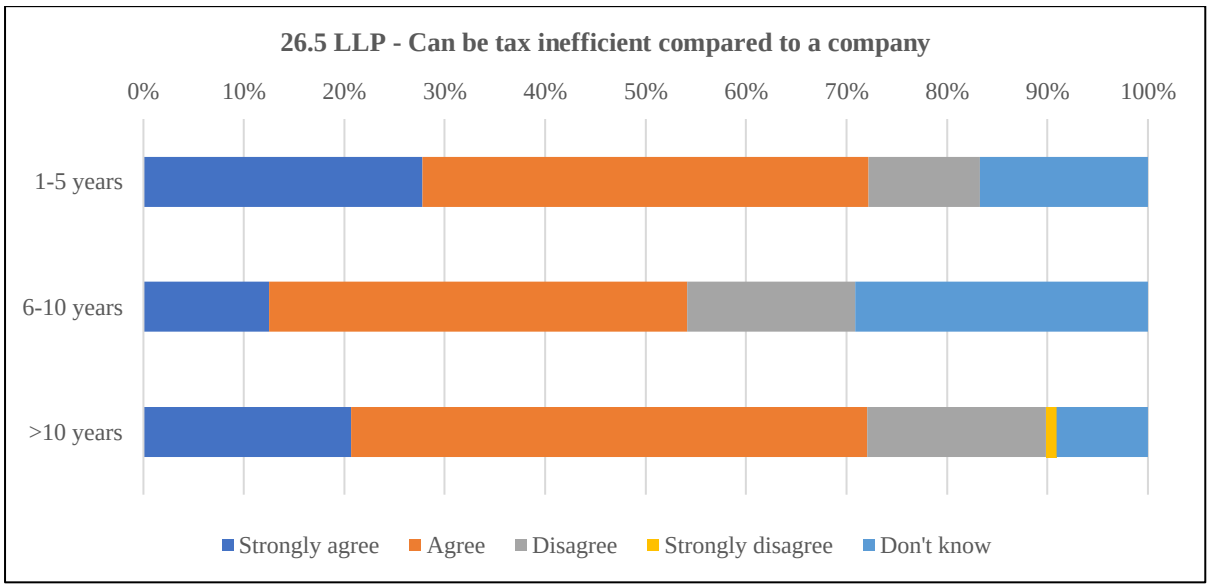
As between respondents that had been advising for 1-5 years and more than 10 years, there was a marginal (0.1%) difference in levels of agreement that the LLP can be tax

766 5/6.

767 Caution should be exercised in respect of this group given the low number of respondents (6).

inefficient compared to a company – 72.2%[768] and 72.1%[769] respectively. The 6–10-year respondents were less confident (54.2%),[770] though still in overall agreement. As with previous questions, this group also returned the highest percentage (29.2%)[771] of 'don't know' responses.

Figure 176: Agreement that tax treatment relative to a company is a disadvantage of the LLP, by reference to experience



Likewise, variations are present when the data is cross-tabulated by firm size, but with no identifiable trend between firm size and respondents' view (Figure 177). Here, the highest

768 13/18.

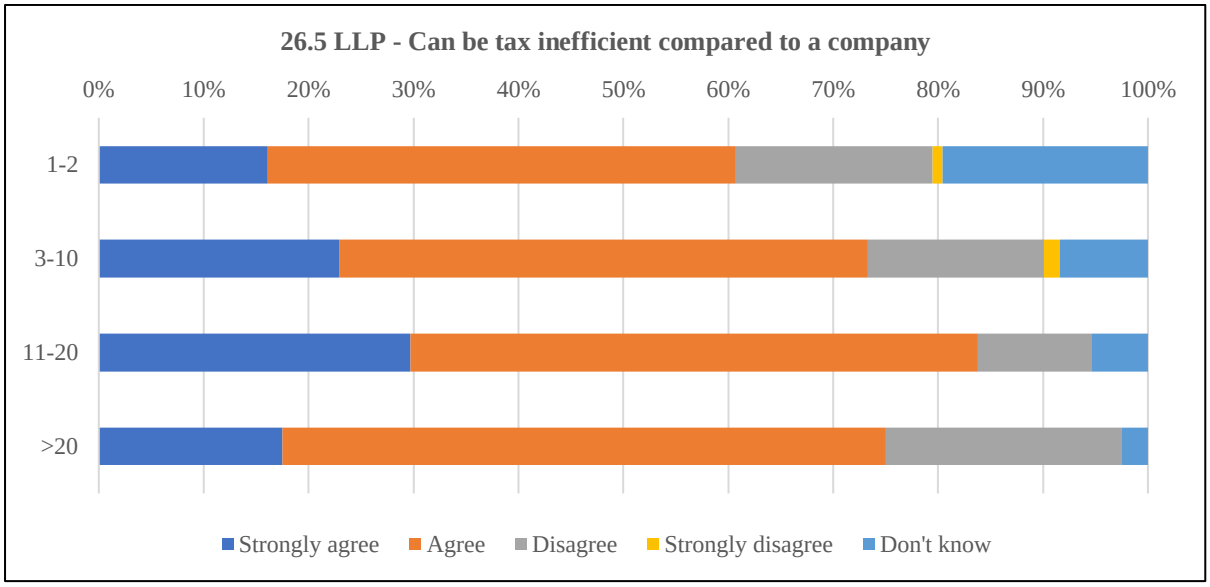
769 199/276.

770 13/24.

771 7/24.

percentage lies in the 11-20 class (83.8% agree),[772] and the lowest in firms with 1-2 accountants (60.7%).[773]

Figure 177: Agreement that tax treatment relative to a company is a disadvantage of the LLP, by reference to firm size



Thus far, this Chapter has considered data which points towards the relevance of tax-based considerations in the selection of form. This is important for two principal reasons. Firstly, the taxation benefits of operating through a company make the partnership, which is viewed as less tax advantageous, a less attractive form for owner-managed business. Financial considerations will be key for owner-managers, and taxation will likely form part of this. Secondly, and consequentially, the above amounts to a fundamental breach of the principle of neutrality; the selection of business form is distorted by the tax regime. Part 4.5 is dedicated to considering the effects of the specific taxation elements upon the behaviour of owner-

772 31/37.

773 68/112.

managers, thereby offering a more complete picture than is derived from considering taxation in the abstract.[774]

4.5 COMPARATIVE TAX POSITIONS

4.5.1 Income Tax, Corporation Tax and NICs[775] – Drawing Down

The majority of owner-managers will need to extract profits from their business in order to pay for their living expenses; this is particularly the case where the business is the sole source of income for the individual concerned, as appears to be the case for approximately 75% of partners in two-person partnerships, and 87% of directors in two-director companies.[776] In such instances, the combined effects of corporation tax, income tax, the cost of NICs and the associated administrative burdens will reasonably be relevant considerations for owner-managers and their advisors since these essentially determine the levels of 'take-home' pay. The author's survey results confirm this. For the purposes of the survey, income/corporation tax and NICs were addressed separately. 98%[777] of the respondents agreed that the taxation treatment of drawn-down profits was an important consideration for owner-managed businesses – 74.4%[778] believed it was 'very important' (Figure 178). This was regarded as the

774 Which Adam, and others, summarise as follows (n 687) 2: 'company owner-managers and the self-employed are particularly responsive to taxes, reflecting their greater scope for income manipulation, tax planning and evasion. Moreover, in recent years company owner-managers have become much more responsive than the self-employed.'

775 OTS Partnerships Interim Report (n 33) 39: '[NICs] are not strictly a tax, though they are collected by HMRC…'.

776 Cribb, Miller and Pope (n 4) 6, 13: 'Combining business and employment activity is common but not new. One-quarter of the self-employed also have some income from employment, but this share has been remarkably stable over time (it was 25%, 24% and 25% in 2000-01, 2007-08 and 2015-16 respectively).' Likewise, 25% of partners in a two-person partnership had income from employment. This figure was lower for those operating as part of a two-director companies where 13% had income from other employment (outside of the technical employment by the company).

777 353/360.

778 268/360.

most important consideration in the list of taxation options offered, which also comprised: tax rates on retained profits; NICs rates; income shifting opportunities; CGT tax planning; availability of research & development ("**R&D"**) tax relief;[779] inheritance tax planning;[780] other.[781] With regard to NICs, 82.4%[782] thought that the matter was important for owner-

[779] R&D tax credits are only available to companies since it operates to offset liability to corporation tax. It is extremely favourable in its application to owner-managed businesses by enabling the company to claim tax relief for 230% of their qualifying revenue expenditure on R&D (defined in accordance with generally accepted accountant practice unless designated otherwise by Treasury Regulations: CTA 2010, s1138). This amounts to a tax saving of 46% of the expenditure (see: Claire Hayes and Ruth Newman, *Tolley's Tax Guide 2021-22* (Lexis Nexis 2021) 29.67. Owner-managers intending to engage in such activities, would therefore be best placed to incorporate from the outset. The author has not taken this point any further as it was subsequently determined as too specific, and the data incomplete. The HM Revenue & Customs Research and Development statistics bunch SMEs claiming R&D tax credits as one group, and it is not possible to determine how many owner-managed businesses are contained within the class. The survey also did not explore the implications of other possible tax credits and reliefs available so the relative impact cannot be determined. The taxation matters discussed in full in this Chapter were the ones that received wider support in terms of their significance for owner-managed businesses and will relevant considerations for all (rather than those engaged in specific types of activity.

For those interested, the survey results on R&D were as follows: 19.9% 'very important' (72/361); 50.7% 'quite important' (183/361); 28% 'not important' (101/361); 1.4% 'don't know' (5/361).

The key statutory provisions are: CTA 2010, s 1138; Finance Act 1998, Sch 18, Pt 9A; FA 2004, s 53; ITTOIA 2005, ss 87-88; The Research and Development (Prescribed Activities) Regulations, SI 2004/712; CTA 2009, s 87 and Pt 13).

See also: HM Revenue & Customs, *Research and Development Tax Credits Statistics*, September 2020 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/921817/Research_and_Development_Tax_Credits_Statistics_September_2020_accessible.pdf> accessed 30 March 2022.

[780] As with R&D Credits, the author has decided not to present this data in full. The option was included as a means to determine the extent to which longer-term tax considerations might be impacting upon the selection of business form, but ultimately it was reported as least important in the list of options presented. Furthermore, whilst their application may differ in practical terms, the two key tax reliefs (namely, Business Property Relief ("**BPR**") and Agricultural Property Relief) are available to those who pass on shares in companies and operate a business through partnership.

For those interested, the survey results were as follows: 15% 'very important' (54/361); 51.8% 'quite important' (187/361); 30.2% 'not important' (109/361); 3% 'don't know' (11/361).

[781] 32 relevant free text responses were received under this heading, which included the following considerations: income spreading; investment reliefs and incentives (including the Seed Enterprise Investment Scheme and Enterprise Investment Scheme); Business Asset Disposal Relief ("**BADR**")(though under the former name of Entrepreneur's Relief); pension-based matters; IR35; mortgage interest relief; stamp duty; the treatment of benefits in kind; BPR; withholding tax; the treatment of intangible assets and VAT.

[782] 295/358.

managed businesses (Figure 179) – 29.3%[783] 'very important'. NICs rates ranked third highest in terms of overall importance in the tax portion of the survey.

Figure 178: Respondents' view as to the importance of income/corporation tax rates on profits paid out to owners[784]

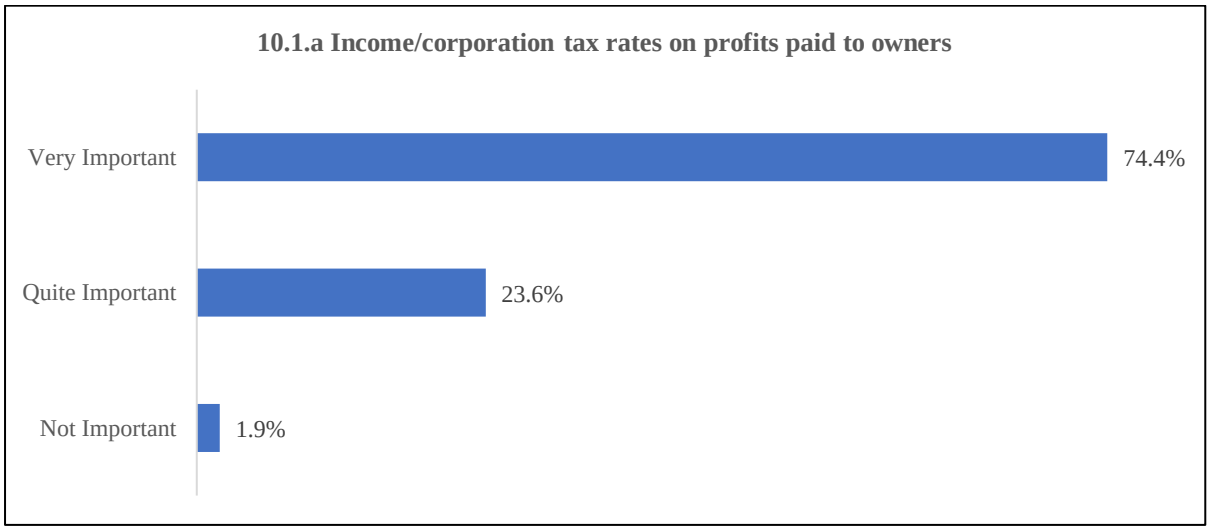
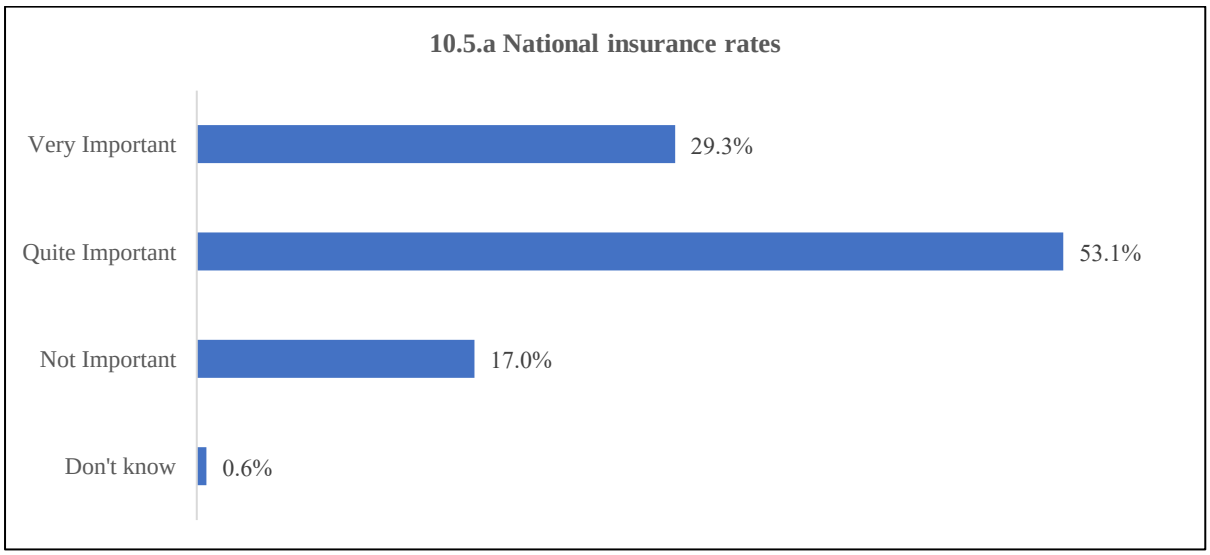


Figure 179: Respondents' view as to the importance of NICs rates for owner-managed businesses

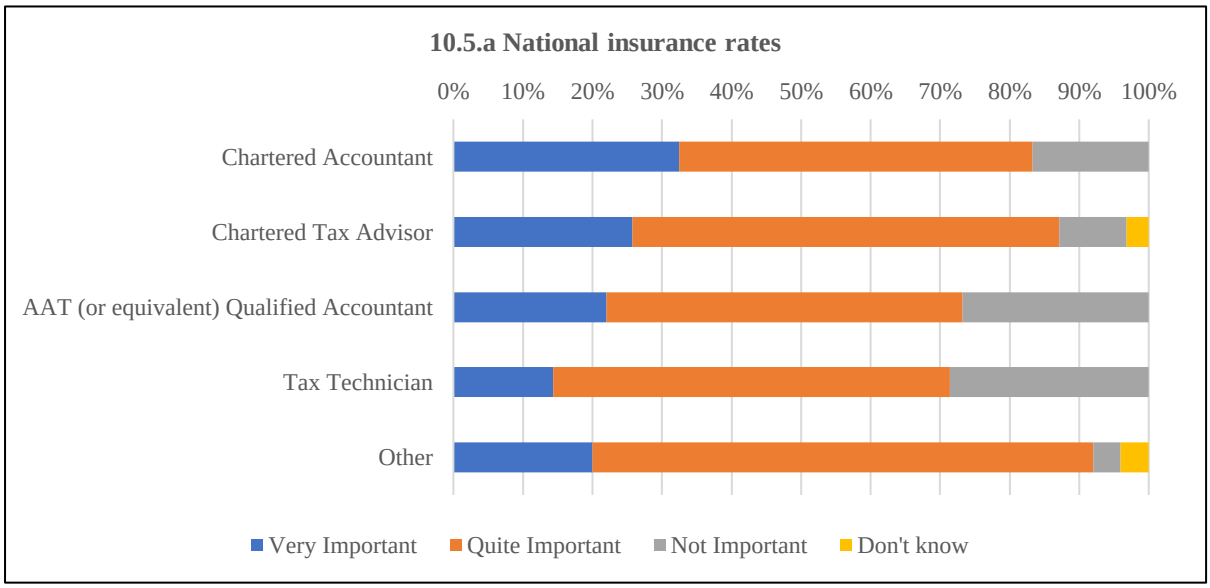


783 105/358.

784 0 'don't know' responses were received.

Whilst cross-tabulation of the data in relation to corporation/income tax treatment does not highlight any differences in opinion between different classes of respondents, the NICs cross-tabulation does reveal a certain degree of disparity. For example, the most qualified (Chartered) and 'Other' category respondents were more likely than the AAT (or equivalent) qualified and Tax Technicians to think that NICs were an important consideration for owner-managed businesses.

Figure 180: Respondents' view as to the importance of NICs rates for owner-managed businesses, by reference to qualification



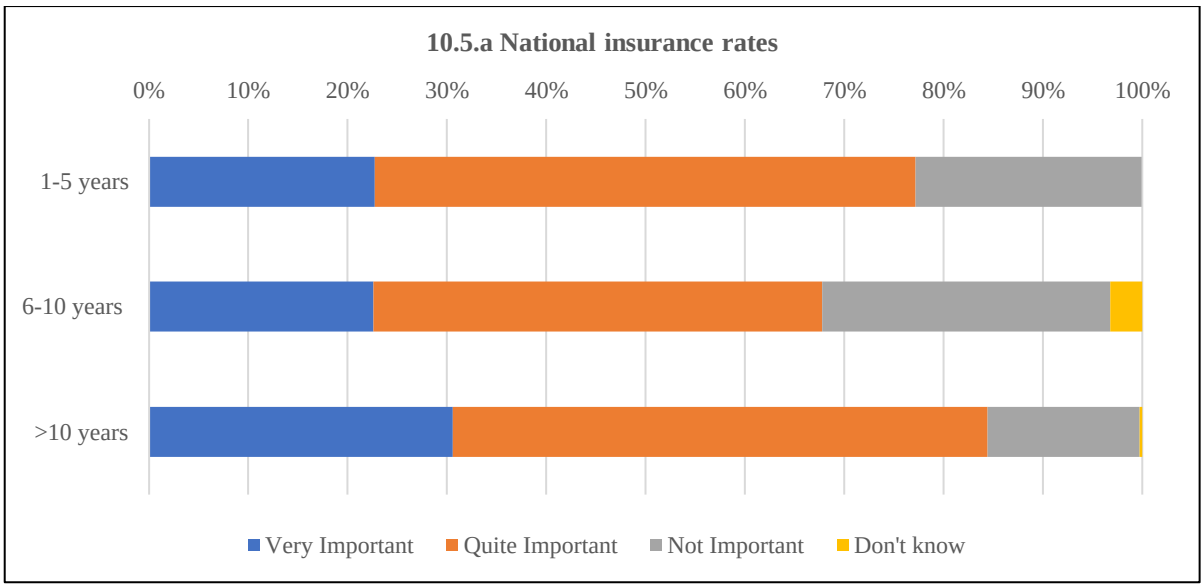
Furthermore, respondents that had been advising owner-managed businesses in relation to form for 6-10 years were significantly less inclined to report NICs as an important consideration (67.8% total)[785] than the other two groups (1-5 years – 81.8%;[786] more than 10 years – 84.4%).[787]

[785] 21/30.

[786] 17/22.

[787] 258/305.

Figure 181: Respondents' view as to the importance of NICs rates for owner-managed businesses, by reference to experience

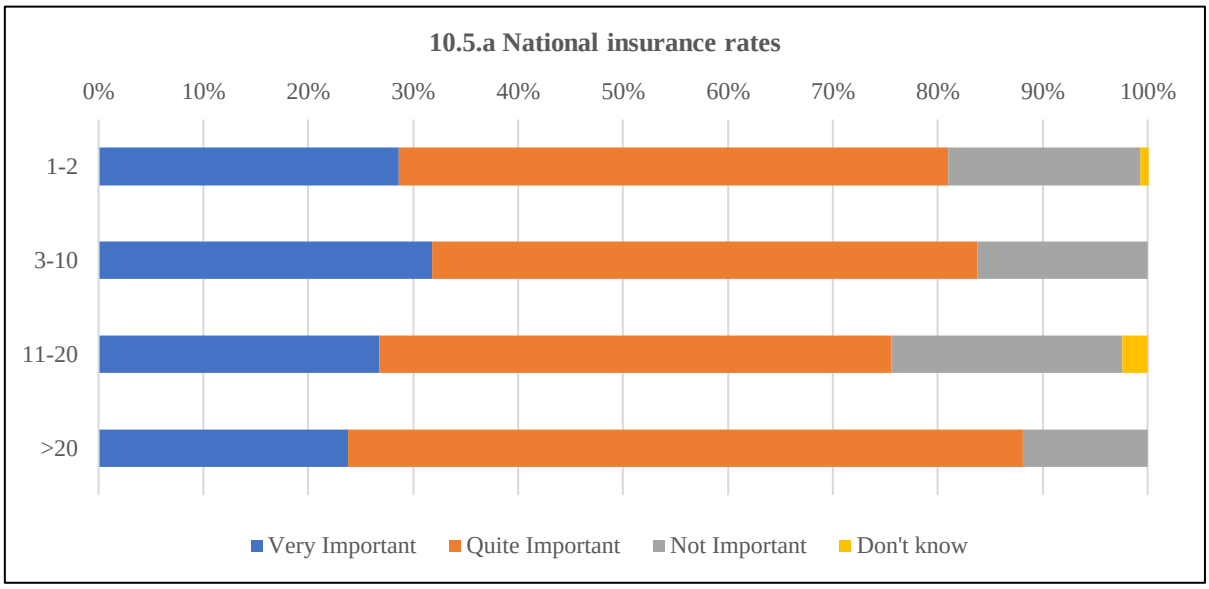


The results of the firm size cross-tabulation highlight the 11-20 firm size category as the anomalous group. 75.6%[788] of these individuals reported that NICs rates are an important consideration for owner-managed businesses - this is 12.5% lower than the figure for more than 20 size firm respondents (88.1%[789] believing that NICs are important) and substantially lower than the figures recorded for all other classes.

788 124/148.

789 37/42.

Figure 182: Respondents' view as to the importance of NICs rates for owner-managed businesses, by reference to firm size



The data overwhelmingly points towards corporation tax, income tax and NICs applied to profits and payments to owner-managers being an important consideration, which may well therefore affect the choice of business form. The following two sections provide more detail as to how these drawn-down profits are taxed under the current regime, thereby highlighting the differences between, and enabling the comparison of, the taxation of partnerships and companies in this respect.

4.5.1.1 Partnerships – Income Tax and NICs

'In many ways, the existence of a partnership is an irrelevance other than as a basis for establishing taxable income.'[790] In the calculation of tax liability, the partnership is only considered to the extent that it provides the foundation for establishing the partners' shares of

[790] OTS Partnerships Interim Report (n 33) 33. ITTOIA 2005, s 848: 'Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners.'

profits. The trading profits must be calculated in accordance with generally accepted accounting practice ("**GAAP**"), subject to any adjustment required or authorised by law in the computation of profits for tax purposes.[791] These profits are then charged to income tax as with any other source of income.[792]

By way of exception to GAAP, a number of small partnerships may elect to make use of a more simplified accounting regime – the cash basis – which enables the individual to calculate profits by reference to money actually received and expended.[793] 'The main practical difference between the standard (accruals) basis and the cash basis is that under the cash basis debtors, creditors and work in progress can effectively be ignored.'[794] It ensures that

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791 ITTOIA 2005, s 25.

792 ITTOIA 2005, s 850(1): 'For any period of account a partner's share of profit or loss of a trade carried on by a firm is determined for income tax purposes in accordance with the firm's profit-sharing arrangements during that period.' The current rates are: 20% basic rate (£12,571 - £50,270); 40% higher rate (£50,270 - £150,000); 45% additional rate (>£150,000). There is no personal allowance on taxable income over £125,140.

793 ITTOIA 2005, s 31A(5). ITTOIA 2005, s 31E:

'(2) To determine the profits of a trade year on the cash basis –

Step 1 Calculate the total amount of receipts of the trade received during the basis for the tax year.

Step 2 Deduct from that amount the total amount of expenses of the trade paid during the basis period for the tax year.

(3) Subsection (2) is subject to any adjustment required or authorised by law in calculating profits for income tax purposes.'

Individuals that have claimed an R&D allowance, or made ITTOIA 2005, s 221 profit averaging election will not be able to use the cash basis. The full list of excluded persons is contained in ITTOIA 2005, s 31C.

794 Constable (n 429) 45.17. The treatment of certain capital expenditure is also different under the cash basis: '[It] is allowable [where it would not otherwise be using the accruals basis] as a deduction in calculating profits and it can be deducted provided it is *not* incurred on:

- the acquisition or disposal of a business or part of a business
- an asset that has a useful life of more than 20 years
- an asset acquired or created for use on a continuing basis in the trade
- a car or land
- education or training

individuals are not taxed on money which is earned, but not received within the tax period. The qualifying conditions are contained in section 31A ITTOIA 2005, and include a provision that business turnover cannot exceed the relevant maximum applicable for the tax year (currently the higher of £150,000 or the VAT threshold or the higher of £300,000 or twice the VAT threshold for those claiming universal credit).[795] However, even the availability of the simplified cash-basis regime for the smallest partnerships does not seem to alleviate the perception that the management of income tax is a complicated and administratively burdensome matter for partners. The OTS analysis of a survey conducted by the Federation of Small Businesses suggested that:

> - income tax was felt to be the most complex area for partnerships. 54 per cent of partnerships in the survey said that income tax was difficult. 72 per cent said it was time consuming;
> - partnerships were much more likely to think that income tax was complicated than other small businesses (HMRC have told us that this contradicts findings of their own customer survey data, which shows no significant difference between partnerships and other small businesses). [796]

Unless specifically exempt,[797] all partners over the age of 16 will be liable for both Class 2 and Class 4 NICs.

> Class 2 contributions are payable at a flat weekly rate and entitle the contributor to short-term contribution-based employment and support allowance, maternity allowance, widowed parent's allowance, state pension and bereavement benefits. Class 4 contributions are payable on all business profits in excess of a specified limit that are chargeable to income tax as trading income…[t]hey carry no entitlement to benefits of any kind.[798]

- an intangible asset broadly with a life of more than 20 years, or
- a financial asset.'

795 ITTOIA 2005, s 31B. A list of excluded persons is included in ITTOIA 2005, s 31C.

796 OTS Partnerships Interim Report (n 33) 18.

797 Social Security Contributions and Benefits Act 1992 ("**SSCBA 1992**"), s 11.

798 Hayes and Newman (n 779) 24.1.

In 2021/22 Class 2 NICs of £3.05 per week are payable where the individual earns more than the small profits threshold of £6,515. Below the small profits threshold, individuals may pay Class 2 NICs on a voluntary basis.[799] Class 4 contributions are paid at a main rate of 9% on trading income that is chargeable to income tax, which falls between specified limits (£9,568 and £50,270 in 2021/22).[800] On profits above the upper profit limit, a 2% rate is payable.[801] All partners are liable to both Class 2 and Class 4 NICs. The OTS has reported that, overall, partners found NICs to be less complicated than income tax. [802]

In addition to filing individual self-assessment tax returns (form SA100), a partnership tax return (form SA800) must also be filed with HMRC.[803] The partnership return is deemed conclusive as to the partners' shares; any disputes may be referred to the Tribunal for determination, and HMRC should be notified of the dispute.[804]

> Data from 2005 suggests that the overall administration burden for unincorporated micro businesses of preparing and completing tax returns and dealing with the associated obligations is over £565 million p.a. Examples of the issues faced by businesses include:
>
> - Lack of financial training and lack of understanding of accounting and tax concepts;
> - Retaining and processing a lot of paper to claim relatively small amounts of expenditure, for example to calculate business use of home; and

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799 SSCBA 1992, s 11. Hayes and Newman (n 779) 24.4: 'unless there are also earnings on which Class 1 contributions are paid it is probably sensible to pay Class 2 contributions voluntarily and maintain the contribution record for social security benefits, particularly the state retirement pension. The contribution record could alternatively be maintained by paying Class 3 voluntary contributions, but these are at a much higher rate than Class 2, being £15.40 a week for 2021/22.'

800 SSCBA 1992, s 15.

801 As with Class 2 NICs, there are exempted persons (SSCBA 1992, s 17).

802 OTS Partnerships Interim Report (n 33) 18.

803 Taxes Management Act 1970 ("**TMA 1970**"), s 12AA.

804 TMA 1970, s 12ABZB.

- Judgements about business use proportions and associated uncertainty over whether HMRC will accept them, for example, business use of telephone where the packages include free minutes and/or services.[805]

Colahan (and others) reported that that the average fees charged by surveyed agents were £248 for filing a partnership return with HMRC and £184 for completing the partnership pages in an individual's tax return.[806] It also appears to be the case that partnerships are less likely to make use of online filing; in the OTS sample, only 24% of the respondent partnerships did so.[807]

4.5.1.2 Company – Corporation Tax, Income Tax and NICs[808]

Taxable business profits for the company are calculated on a similar basis to the partnership, with the exception that cash basis accounting is not available in any case. Instead, the GAAP

805 OTS Small Business Tax Review Interim Report 2011 (n 273) 24.

806 (n 690) 34. This is less than the figures reported by the business owners, however 'there is evidence that businesses may be overstating the fees charged by agents because they are unable to break the fees down to the level of obligation.'

807 OTS Partnerships Interim Report (n 33) 18. Partnerships were also more likely to rate HMRC's clarity in communicating as poor.

808 Company owner-managers will also need to be mindful of the national minimum wage ("**NMW**") and national living wage ("**NLW**") standards. However, according to Inland Revenue Bulletin 50, December 2000 <https://webarchive.nationalarchives.gov.uk/ukgwa/20110617040635/http://www.hmrc.gov.uk///bulletins/archive27to52.htm> accessed 30 March 2022: 'If a person is a director and he does not have an explicit employment contract, then he is highly unlikely to be subject to the NMW legislation even when he carries out a wide variety of activities. These might include, for example, working in the company's shop. Such activities can be done in his capacity as an office holder (director), rather than as a worker. If a director has an explicit employment contract he will be within NMW in respect of earnings under that contract as he and the company will then have chosen to create a worker/employer relationship alongside the director/company one… The DTI [Department of Trade and Industry] have told us that if there is no written employment contract or other evidence of an intention to create an employer/worker relationship they will not seek to contend that there is an unwritten or implied employment relationship between a director and his company. As the Inland Revenue administers NMW as agents for the DTI they will adopt this policy also. The DTI are aware that this position has been represented in some quarters as a change in policy by the Government. But they point out that the Government has always made clear that directors would only be covered by the law if they were also workers as defined by the Act and that remains the case.'

standard accruals basis must be used.[809] This has been highlighted as an issue by the OTS Small Company Tax Review.

> Small companies and accountants told us that, for many, it's not just the tax treatment that is complicated but the requirement to file accounts according to generally accepted accounting principles (GAAP)…Some of the accountants we spoke with raised this as a genuine concern, saying that they often produced accounts that were of little use to the owner because the owners didn't understand the accounts. The accounts simply became a reporting requirement rather than an aid to business.

All company profits are subject to corporation tax (at a rate of 19% in 2021/22). 'Profits' includes income and chargeable gains,[810] though an annual tax on enveloped dwellings[811] is also payable upon high value residential property and the 28% CGT rate is applicable to disposals thereof. Any salary paid to the company owner-manager will be a deductible expense for corporation tax purposes. Income tax will also be deductible at source (via PAYE)[812] at the applicable rates where the personal allowance is exceeded.

> For 2021/22, profit taken as pay costs the company 13.8% Class 1 NICs on pay in excess of £170 a week (unless the employee is aged under 21 or an apprentice aged under 25…), but the contributions are deducted in arriving at taxable profits for corporation tax purposes. Class 1 or Class 1A NICs are also payable on virtually all taxable benefits in kind…Employees also do not have to pay NICs on the first £184 a week, but those earning £120 or more have their rights to state benefits protected. From 6 April 2021, the rate of employees' contributions on earnings between £184 and £967 per week is 12% and

809 CTA 2009, s 46.

810 CTA 2009, s 2.

811 Finance Act 2013 ("**FA 2013**"), Pt 2, Ch 2. This is highly unlikely to be of interest to the typical owner-manager.

812 The need to register and operate PAYE (along with the associated payroll systems) imposes a significant administrative burden on company owner-managers, though PAYE Tools software is available to download from the GOV.UK website <https://www.gov.uk/basic-paye-tools> accessed 3 April 2022. Rayney (n 69) 290 warns that '[t]heir drawings from the business become subject to PAYE rules, which can cause cash flow problems, both for the business and for the proprietors.' Hayes and Newman (n 779) 10.68: 'The payments to HMRC must be made within 14 days after the end of each income tax month…'.

> employees must also pay contributions at 2% on all earnings above £967 a week.[813]

Profits drawn down as dividends are not deductible in the computation of profits for corporation tax purposes, nor are they subject to NICs of any class. In 2021/22, the first £2,000 of paid-out dividends is not taxable in the hands of the individual.[814] Above this threshold, the tax rate is 7.5% up to the basic rate taxpayer limit, 32.5% on income between the basic and higher rate limit, and 38.1% on income above the higher rate limit.[815] Company owner-managers have a great degree of flexibility in the remuneration strategy, the effects of which are explored below (Examples 1-4).

Companies must file the return form CT 600 along with supporting accounts and computations with HMRC 12 months after the end of the relevant accounting period (or three months after receiving a notice to deliver a return if later).[816] Section 93 Finance Act 2007 makes online filing of the corporation tax return mandatory. The OTS Small Company Taxation Review concluded that:

> [m]any of the small companies we spoke with found corporation tax particularly difficult to deal with…

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813 Hayes and Newman (n 779) 12.2. See also 12.11: 'Employees are charged to tax on the cash equivalent of benefits provided either for them or for their family or household…In most cases…it will usually be equally tax/NICs efficient, and far more straightforward, to provide cash pay rather than benefits.'

814 ITTOIA 2005, s 383(1) provides for the charge to tax on dividend distributions from a UK resident company.

815 Up until 6 April 2016, the taxation of dividends was more generous. A notional 10% tax credit was given to the shareholder, and taxpayers within the basic rate tax band did not pay any income tax on the amount received. Above this level, higher rate taxpayers were charged to income tax at an effective rate 25%, and the additional rate was levied at an effective rate of 30.56% (unless the dividend was paid before 6 April 2013, when the effective rate was 36.11%). The tax credit was available irrespective of whether the company had, in fact, paid corporation tax in the relevant tax year.

816 See TMA 1970, ss 59D-E.

> Incorporating creates a significant problem for many micro businesses, especially nanos. Many proprietors simply do not understand the accounting and tax requirements of a company…
>
> The tax system…puts disproportionate administrative burdens on smaller companies. Micro companies spend an average of at least 27p in advisory fees for every £1 of corporation tax they pay.[817]

76% of the respondents surveyed by the OTS as part of the above review said that 'they would rather leave corporation tax to their accountants than get to a position where they felt comfortable dealing with it themselves. This was higher than for any other tax.'[818] This is consistent with the research findings of Colahan, Joyce and Klahr: '[b]usinesses' use of agents was widespread for preparing and filing the Corporation Tax Return. Three-quarters of businesses (74%) completely outsourced their CT600 Return to an agent, whilst 17% outsourced some of the work.'[819]

Any employment income paid to the owner-managers will be reported to HMRC by the company operation of PAYE.[820] There are no additional obligations imposed upon the owner-managers in their personal capacity in this respect. Dividend payments made over and above the dividend allowance must be reported by each recipient to HMRC. If the dividend payment exceeds £10,000, this needs to be included in a self-assessment tax return. Otherwise,

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817 OTS Small Company Tax Review (n 40) 9, 13 and: 'the easiest way to simplify the tax burden for these companies would be to remove them from the corporation tax system altogether.'

818 OTS Small Company Tax Review (n 40) 13.

819 Colahan and others (n 690) 25: 'Reasons for using an agent were linked to a lack of confidence and fear of submitting incorrect information, a lack of time, and a desire to benefit from the agent's specialist tax knowledge…'.

820 All payments must be reported, even if they are below the NICs lower earnings limited of £120 per week. Hayes and Newman (n 779) 10.61: 'Under Real Time Information (RTI) an employer pays PAYE electronically and sends HMRC details of an employee's pay and deductions for tax, NICs, and student loan deductions together with the payee's identity at the time that the employee is paid. The information to be submitted is produced from computerise payroll systems and is submitted automatically as part of the process for making payments to HMRC.'

individuals can choose make use of the HMRC helpline, and tax may be deducted at source from other earnings (or pay by self-assessment).[821]

4.5.1.3 The Partnership-Company Comparison - Profits

The calculation of the exact income threshold beyond which incorporation is broadly tax efficient inevitably depends on various factors; owner-managed entities are extremely diverse and the manner in which they operate is not always the same.[822] Relevant considerations include, inter alia, whether the individual has any other sources of income, how profits are extracted and whether pension contributions are paid.[823] Given the existence of such variables, some simplified scenarios are presented herein for the purpose of facilitating discussion and the making of observations. Even if the following account does not accurately reflect the position of all owner-managed businesses, the general position will impact upon the overall impression of the desirability of different forms, thereby feeding into the cultural element of form selection; if the form is generally viewed as favourable from a tax perspective (or otherwise), then it is more likely to be adopted, even outside of the basic case.

'The precise break-even point largely depends on the level of profits the proprietor needs to extract to satisfy his living expenses and other personal requirements and how they are taken out, such as through remuneration or dividends.'[824] Rayney suggests that many

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821 <https://www.gov.uk/tax-on-dividends> accessed 19 April 2022.

822 Small Company Taxation Review (n 40) 24. Hayes and Newman (n 779) 18.2: 'There are so many variables to take into account in comparing the tax/NICs position for the unincorporated…and the company director that it is impossible to draw hard and fast conclusions, and detailed calculations need to be made in every case.'

823 Pension planning is discussed in detail at Part 4.5.5.

824 Rayney (n 69) 284.

practitioners tend to adopt a general 'rule of thumb' view that incorporation is almost certainly beneficial where the future profits of the business are consistently well in excess of £80,000 (this also accounts for the increase in legal compliance costs of running a company etc).[825] The HMRC Reasons Behind Incorporation report also noted that businesses with the smallest turnovers in 2012/13 (under £25,000) were the least likely to incorporate for tax and national insurance ("**NI**") reasons (12% did so, compared to 19% of the overall sample, though even 12% incorporating for tax and NI reasons is less than desirable), presumably because the potential for savings is lower. Over the same period, profit-making businesses were more likely to incorporate for tax and NI reasons (24% of the total sample, compared to 10% of those who broke even, and 11% of loss-making businesses).[826] The supposed rationale for the £80,000 threshold is that once this is surpassed there is a clear ability to mitigate the top income tax rates, making incorporation a 'no brainer'.[827] As previously explained, the majority of owner-managed businesses will not surpass this threshold, making the decision to incorporate a less obvious choice. Rayney believes that the advertised taxation benefits of incorporation for low-yield owner-managed businesses may be overstated; '[t]he tax benefits of incorporation are fairly marginal for businesses with low profits, although modest savings can still be made (due

825 Rayney (n 68) 27.2. This is consistent with the advice in Palmer's (n 56) 2.2.10: 'business people should consider taxation issues in order to determine whether incorporation would be tax efficient for themselves and their businesses. The scheme of company taxation, under the imputation system of corporation tax now in operation, may offer advantages from the point of view of taxation to the individual trader or partner in the higher tax brackets. Such a company will, almost inevitably, be a "close company" for tax purposes…A trading company whose trading income is above a certain level and which has a good prospect of rapid expansion will probably pay less tax than a private trader or a partnership in a similar position.'

826 HMRC Reasons Behind Incorporation (n 25) 30, 32: 'One respondent looked at the issue from a purely financial perspective, and calculated that once her income had reached a certain point, it would be more beneficial to be a limited company. "By setting up the company I was able to reduce the effective tax rate considerably, and in addition I was able to charge all my expenses and deduct those expenses from what I did end up paying in Corporation Tax" (agricultural sector, trading with same ownership).'

827 This is supported by the findings of the HMRC Reasons Behind Incorporation study (n 25) 4, which reported that individuals with higher levels of remuneration (classed as >£50,000) were most likely to recommend incorporation than those with lesser returns (94% would recommend).

to the beneficial tax treatment of dividends for basic rate taxpayers).'[828] Nonetheless, there are still tax savings to be made by operating as a company at lower profit levels, even if these are arguably outweighed by the associated administrative burdens.

'The overall comparative tax position is significantly affected by whether profits are withdrawn as salary or dividends.'[829] A popular remuneration strategy for company owner-managers appears to be the utilisation of a combination of salary and dividends,[830] particularly where there is use of an external agent.[831] Keilloh, Chhatralia and Johnson's empirical research made the following findings:

> [s]alaries were the most common form of director remuneration (provided by 67% of companies), followed by dividend payments (58%); almost half the companies used both. Company remuneration strategies were commonly chosen to maximise tax efficiencies. Around a quarter of companies whose directors were remunerated cited tax as a factor in their remuneration decisions. This is reflected in the fact that, where paid, salaries tended to be of low monetary value, with two in five (41%) of these companies stating that their main directors' salary was below £10,000, and dividend payments tended to be higher than salaries [for tax reasons]…a quarter (25%) of companies who remunerated their main director this way stated that the dividend amounted to between £1 and £10,000, while 22% paid between £10,000 and £20,000, a

828 Rayney (n 68) 27.3. Though above the higher rate threshold, turning income into capital gains is likely to be the most tax advantageous course of action. This is discussed further below. Adam and Miller (n 4) 8: 'The tax advantage associated with different forms of income varies with the overall levels of income. In the basic-rate tax band, dividends are the lowest taxed form of income; above the higher-rate threshold, the biggest advantage is for capital gains.'

829 Hayes and Newman (n 779) 18.6.

830 HMRC Reasons Behind Incorporation (n 25) 3, 28-29, 37 found that their respondents were more likely to say that they decided to incorporate because of tax and NI savings if they used a remuneration strategy which combined salary and dividend payments. This category of respondents was also more likely to report tax and NICs treatment as a benefit of incorporation. Overall, 37% of the respondents used a combined salary and dividend remuneration strategy (the most popular). 20% used dividends only and 18% used salary only. The report does not account for the remaining 25%.

831 HMRC Reasons Behind Incorporation (n 25) 60: 'The use of an external agent was higher among companies that had a remuneration strategy of combined salary and dividends (69 per cent).'

> further 16% paid between £20,000 and £30,000, and 8% paid dividends of £50,000 or more.[832]

The HMRC Reasons Behind Incorporation study also highlighted that:

> [t]hose using a combination of salary and dividends were usually aware of the 20 per cent tax rate associated with dividends (this is the combined effective rate of corporate tax and income tax on dividends for basic rate taxpayers). Often this strategy involved a minimum salary (in line with income tax thresholds) with the remainder drawn in dividends.[833]

The practical implications of using combined remuneration strategy as compared to a purely salary-based approach are illustrated by the following example by Hayes and Newman (based upon a £25,000 company profit):[834]

832 Graham Keilloh, Krishna Chhatralia and Claire Johnson, HM Revenue and Customs Research Report No.390, *Profit Distribution and Investment Patterns of Unlisted Companies,* September 2015, 4, 16.

833 HMRC Reasons Behind Incorporation (n 25) 49.

834 Hayes and Newman (n 779) 12.4.

Example 1

Company uses profits of £25,000 in the year to 31 March 2022 to make a payment to director/shareholder (not a Scottish taxpayer) who has no other income…Mr director's personal allowance for 2021/22 is £12,570.

	Salary Only	Salary and dividends
	£	£
Company's tax position on the profits:		
Profits	25,000	25,000
Salary	(23,041)	(12,570)
Employer's NICs	(1,959)	(514)
Taxable profits		11,916
Corporation tax @19%		(2,264)
Director's dividend income		9,652
Director's tax position		
Salary	23,041	12,570
Dividend		9,652
	23,041	22,222
Personal allowance	(12,570)	(12,570)
Taxable income	10,471	9,652
Tax payable on salary (@20%)	2,094	
Tax payable on dividends (£2,000 @0%; £7,652 @7.5%)		574
Disposable income:	23,041	12,570
Employee's NICs	(1,617)	(361)
Dividend		9,652
Tax	(2,094)	(574)
	19,330	21,287
Saving through paying dividend		**£1,958**

The saving of £1,958 through paying the dividend is made up as follows:

	£	£
Extra income available as dividend through saving in employer's NICs (£1,959-£514)	1,445	
Less: 19% corporation tax thereon (i.e. reduced tax relief for employer's NICs)	(275)	1,170

On the balance of taxable profits, i.e. £11,916-£1,445 = £10,471:		
Company pays corporation tax £10,471 @ 19%	(1,989)	
Director saves income tax £10,471 @ 20% on salary	2,094	105
Director pays income tax on dividends		(574)
Reduction in employee's NICs (£1,617-£361)		1,257
		£1,958

The crucial take-home point is that at the £25,000 profit margin, a tax saving of £1,958 can be made by using a remuneration strategy that combines salary and dividends (assuming that there are no other sources of income). Unsurprisingly, the respondents to the HMRC Reasons Behind Incorporation study that structured the draw-down of profits in this way were more likely to recommend incorporation than those who did not take advantage of the dividend allowance and tax rates (84% compared with 73% of those not using dividends). [835]

The following example demonstrates the potential savings available for higher and additional rate taxpayers (payment by way of dividend results in a 3.71% lower effective tax rate for higher rate taxpayers than if money was paid out by way of salary, and a 3.56% lower effective tax rate for additional rate taxpayers):[836]

835 HMRC Reasons Behind Incorporation (n 25) 4.

836 Hayes and Newman (n 779) 12.4.

Example 2

Mrs director is liable to tax at 40% and already drawing salary such that she is paying maximum NICs at the 12% rate, In addition she has already received more than £2,000 in dividends so has no dividend allowance available. The effective tax rate on payment of an extra £100 of profit as either salary or a dividend as follows.

(a) salary payment

	£	£
Available profit		100.00
Employer's NICs on salary (13.8% of £87.88)		12.13
Gross salary*		87.87
Tax @ 40%	35.15	
Employee's NICs @ 2%	1.76	36.91
Net income		**50.97**
Effective tax rate on available profit		**49.03%**

(b) dividend payment

Available profit		100.00
Corporation tax @ 19%		19.00
Cash dividend payable to shareholder		81.00
Tax @ 32.5%		26.32
Net income		54.68
Effective tax rate		**45.32%**

* £100 profit is employer's NICs inclusive. Gross salary is £100 x 100/113.8

Mrs director is liable to tax at 45% and already drawing salary such that she is paying maximum NICs at the 12% rate. In addition, she has already received more than £2,000 in dividends so has no dividend allowance available. The effective tax rate on payment of an extra £100 of profit as either salary or a dividend is as follows.

(a) salary payment

	£	£
Available profit		100.00
Employer's NICs on salary (13.8% of £87.88)		12.12
Gross salary*		87.88
Tax @ 45%	39.54	

Employee's NICs @ 2%	1.76	41.30
Net income		**46.58**
Effective tax rate on available profit		**53.42%**
(b) dividend payment		
Available profit		100.00
Corporation tax @ 19%		19.00
Cash dividend payable to shareholder		81.00
Tax @ 38.1%		30.86
Net income		50.14
Effective tax rate		**49.86%**

Dividends for shareholders in the above Examples are therefore more tax-effective than salary, mainly because of the NICs cost of a salary.

The simple look through treatment afforded to partnerships means that there is no option to select a remuneration strategy based upon tax considerations; partners are simply liable to tax on their share of profit and they may do with them as they so wish. Examples 3 and 4 below replicate, with minor amendments, those produced by Hayes and Newman.[837]

> Example [3] shows that in 2021/22, if an individual (who is not a Scottish taxpayer…) with no other income is paid a salary of £50,270 by a company to leave him with taxable income equal to the basic rate threshold of £37,700, the profit level at which the tax burden using the company equates with that of an individual trader [or partner] is £75,036…The turning point would be at a lower profit level on a salary of less than £50,270, and a higher level on a salary above £50,270.

Example 3 also highlights that where money is paid out from the company by way of salary, the requirement to pay both employer and employee (Class 1) NICs results in the NICs cost of operating through a company being significantly higher than for unincorporated businesses.

837 Hayes and Newman (n 779) 18.8.

Example 3

Business profits before tax and NICs are £75,026 and there are no other income sources. A partner is liable to income tax on the full amount. If a company director was paid a salary of £50,270 during 2021/22 (which after the personal allowance of £12,750 leaves income of £37,700 to use the basic rate band), the comparative position is:

			Partner		**Company director**
			£		**£**
Profits/remuneration			75,026		50,270
Personal allowance			(12,570)		(12,570)
Taxable income			62,456		37,700
Tax thereon:	37,700	@20%	7,540		7,540
	24,756	@40%	9,902		
			17,442		7,540
Class 2 NICs (flat rate)			159	Employee's NICs**	4,884
Class 4 NICs*			4,158		
			21,759		12,424
Total personal tax and NICs					
Company's tax and NICs					
Profits				75,026	
Less: Director's remuneration				(50,270)	
Company's NICs thereon				(5,717†)	5,717
Taxable profits				19,039	
Tax thereon @ 19%				(3,617)	3,617
Retained profits ††				15,422	

Total tax and NICs liabilities		21,759		21,759
Drawn or undrawn profits		53,267		53,267
		75,026		75,026
*	On (50,270 - 9,568) @ 9%		3,663	
	On (75,026 - 50,270) @ 2%		495	4,158
**	On (50,270 - 9,568) @ 12%			4,884
†	On (50,270 - 8,840) @ 13.8%			5,717

Each extra £1 of profit would cost the partner 42p in tax and NICs (until such time that their income exceeds the additional threshold of £150,000, in which case it would be 47p) and the company 19p.

Possible further tax liabilities if the company's retained profits of £15,422 (see ††) are paid out:

If distributed as dividends, the first £2,000 would not be taxable. The balance of £13,422 taxed at 32.5%	£4,362
If taxed as capital gains, 20% on £15,422 (or 10% i.e. £1,542 if business asset disposal relief (formerly known as entrepreneur's relief) is available)	£3,084

Example 4 demonstrates the tax savings that can be made by incorporating and distributing profits through a combination of salary and dividend payments (as compared to operating in partnership). It evidences that small tax savings can accrue at a profit level of just £27,000.[838] The break point is therefore much lower when the combined remuneration strategy is utilised by the company owner-manager.

838 Hayes and Newman (n 779) 18.8. Recall that the OTS Partnerships Interim Report (n 33) reported that of the existing partnerships 33% had a turnover of less than £30,000 and 55% had a turnover of less than £75,000 – though turnover is not the same as profits – meaning that savings are potentially made here.

Example 4

Say total profits for 2021/22 are £27,000 and there are no other sources of income. The comparative position for a partner compared with a company director who is paid a salary of £13,500 and receives the balance after corporation tax as a dividend is as follows:

	Partner		**Company director**
	£		**£**
Profits/remuneration	27,700		13,500
Personal allowance	(12,570)		(12,570)
Taxable income	14,430		930
Tax thereon @ 20%	2,886		186
Class 2 NICs (flat rate)	159	Employee's NICs**	472
Class 4 NICs*	1,529		
Total personal tax and NICs	4,614		658
Company's tax and NICs			
Profits		27,000	
Less: Director's remuneration		(13,500)	
Company's NICs thereon		(643†)	643
Taxable profits		12,857	
Tax thereon @ 19%		(2,443)	2,433
Dividend		10,414	
Tax thereon:			
£2,000 @ 0%			
£8,414 @ 7.5%			631
	4,614		4,375
Saving through operating as a company:			£239

* On (27,000 - 9,568) @ 9%

**	On (13,500 - 9,568) @ 12%
†	On (13,500 - 8,840) @ 13.8%

Note also that payment of Class 1 employee and employer NICs, as well as income tax, can be avoided entirely by company owner-managers. This is achieved by paying a salary up to the NICs Secondary Threshold amount (£737 per month in 2021-22) and extracting the rest of the profits by way of dividend. The owner-manager still maintains the benefits of paying NICs at this level, even though it has not in fact been paid.

The overall position is concerning if one takes into account the principles outlined in Part 3. Owner-managers engaged in similar activities face differential tax burdens upon money extracted from the business for personal use, which produces horizontal inequity. Adam and Miller have argued that there is no justification for the gulf in tax treatment between the employed and self-employed (including company owner-managers),[839] but the argument is even stronger as between the self-employed (partners) and company owner-managers that engage in materially similar activities. 'To the extent that it is possible to describe the stereotypical closely-held business, it is not one that makes substantial investments or goes on to grow';[840] this observation applies irrespective of form. Both groups of owner-managers are engaged in 'risk-based' activity and have equal access to social security benefits (assuming that the company owner-manager is sensible enough to extract a salary at least to the level of the NICs Lower Earnings Limit, and the partnership is sufficiently profitable to trigger the

839 Adam and Miller (n 664) 107-112.

840 Adam and Miller (n 664) 110. Keilloh, Chhatralia and Johnson (n 832) found that 62% of non-director employee companies did not expect to grow. 14% of companies with no staff did not retain profits, and these companies were less likely to hold net assets.

payment of NICs).[841] Indeed, if there is any case for differential treatment, it would be made in favour of taxing the company owner-manager *more* heavily than the partner because the state provides a benefit in the form of limited liability protection. On the other hand, this is arguably paid for by way of the additional administrative burdens and duties imposed upon company directors; the imposition of a further the tax penalty might be regarded as excessive. In any event, the increased tax burden borne by partners engaged in economically similar activity is extremely difficult to justify; horizontal equity has not been achieved. The existence of the opportunity for tax savings, even at low profit levels, combined with the fact that owner-managed business advisors regard the taxation effects on drawn-down profits highly important for owner-managers, mean that it is reasonable to assume that the taxation treatment of withdrawn profits is, at least to some extent, influencing the decision to incorporate. This is supported by the findings of the OTS[842] and numerous others.[843] This generates a situation where the 'tax tail' is, in some instances, wagging the 'commercial dog',[844] thereby amounting to a breach of the neutrality principle, leading to deadweight efficiency losses. Furthermore, the administrative and compliance burdens associated with both forms appear to be problematic for owner-managers. Partners find income tax complicated, leading to the need to employ an accountant for compliance. For close owner-managed partnerships, the need to file a separate partnership tax return results in a duplication of effort, though HMRC have been resistant to the abolition of the partnership tax return, even for small partnerships.[845] For the company

841 These arguments are often used to justify the differential treatment of the employed and self-employed. They are convincingly rebutted by Adam and Miller (n 664) 107-112.

842 OTS Small Company Taxation Review (n 40).

843 See, for example: Freedman and Godwin (n 32); Cribb, Miller and Pope (n 4); Adam and Miller (n 4 and 664); HMRC Reasons Behind Incorporation (n 25).

844 Hayes and Newman (n 779) 8.16.

845 OTS Partnership Review (n 164) 53.

owner-manager, the need to operate PAYE, file company returns, and ensure that Class 1 NICs are appropriately managed imposes additional costs. However, these are associated with the separate legal personality of the company, and might be regarded as unavoidable (or at least difficult to avoid).

4.5.1.4 The Partnership-Company Comparison - Losses

Thus far, the discussion has proceeded upon the premise that the owner-managed business makes a profit, but that is not always the case, particularly in the early stages of operation.[846] The treatment of losses for partners and companies once again differs. In respect of the former, generally the following reliefs are available:[847]

(a) Losses can be carried forward against subsequent profits arising from the *same business;*[848]

---

846 Cribb, Miller and Pope (n 4) 22 'loss-making businesses are disproportionately likely to be in their first or second year of trading and deductions for plant and machinery investment make up a greater share of their costs.'

847 Hayes and Newman (n 779) 23.15: 'Relief for partnership trading losses may be claimed by each partner quite independently of the others. Thus one partner may decide to carry forward their share of the loss, another to set theirs against any income of the previous tax year, another to carry back against the income of the previous three tax years in their early years of being a partner and so on.'

848 ITA 2007, s 83. Hayes and Newman (n 779) 25.5: 'There are obvious disadvantages in carrying forward a loss. The trade may cease, or its nature change, before the loss is fully relieved. There is also a considerable delay before the loss results in a cash saving by reducing or eliminating a tax liability.'

(b) Losses may be deducted against *general income* in the same tax year and/or the previous tax year[849] – note that this will be of use to owner-managers with other sources of income. The taxpayer may also elect to extend the set off against any capital gains;[850]

(c) Losses from a *new trade* can be carried back against *general income* of the previous three tax years (the earliest comes first);[851]

(d) If a loss occurs upon the cessation of trade, it may be set off against *trading income* of the final tax year of trading, and then carried back against the *trading income* of the previous three tax years (the most recent comes first).[852]

'It should be noted that if trading losses are used against non-trading income for income tax purposes, those trading losses will still be available to be carried forward for the purposes of Class 4 NICs.'[853] Businesses making use of the cash basis cannot use the sideways loss relief or CGT relief in (b) and (c). Caps also apply to losses offset against general income.[854] The

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849 ITA 2007, s 64.

Hayes and Newman (n 779) 25.3: 'Typically, a claim under ITA 2007, s 64 must first be made against general income of either the year of loss and/or the previous year before a claim under the extended carry back rules is possible. However, if the individual has no income to claim against in the current or previous tax year, it is still possible to make a claim under the extended loss carry back rules for the earlier two years. The amount that may be carried back more than one year is capped at £2 million and any such loss is relievable only against profits from the same trade arising in the earlier two years. A separate cap applies for each tax year – i.e. a cap of £2 million applies for losses in 2020/21 and a separate £2 million cap for losses in 2021/22. For partnerships, each partner is entitled to their own individual £2 million limit.'

850 ITA 2007, s 71; TCGA 1992, s 261B.

Hayes and Newman (n 779) 25.3: 'For losses incurred in 2020/21 or 2021/22, Finance Act 2021 ("**FA 2021**"), Sch 2, Pt 1 provides a temporary extension to the carry back period for trading losses from one year to three years. The extended relief applies equally to losses incurred from a profession or vocation but does not apply to losses sustained by a furnished holiday lettings business.'

851 ITA 2007, s 72.

852 ITA 2007, ss 89-90.

853 Constable (n 429) 45.28.

854 As do anti-avoidance rules for 'tax-generated losses': ITA 2007, s 74ZA.

current applicable limit is the greater of £50,000 or 25% of the individual's adjusted total income for the tax year.[855] Partners (and LLP members) in trade also need to be aware of the following:[856]

> [t]here are anti-avoidance rules to prevent manipulation by individuals of the tax reliefs for partnership losses. They affect "non-active partners", i.e. those who do not spend at least 10 hours a week personally engaged in the activities of a trade whose activities are carried on on a commercial basis and with a view to realising profits.
>
> The rules apply to losses arising in the first four tax years in which the partner carried on the trade, and do not therefore apply to professions. They prevent such partners…claiming relief for losses against non-trading income and capital gains to a greater extent than the amount of their capital contribution and profit share…Furthermore for losses arising on or after that date [2 March 2007], there is an annual limit of £25,000 on the amount of trading losses for which non-active partners will be able to claim relief against other income/gains (subject to an exclusion for certain film-related expenditure).

Companies may also offset losses in a flexible manner. In respect of trading losses, the options are as follows:[857]

(a) Losses in the *current year* can be set-off against profits from *other sources* in the same year:[858]

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855 Hayes and Newman (n 779) 2.11.

856 ITA 2007, ss 102-115, 790-795. There are also anti-avoidance provisions that apply to mixed member partnerships (ITA 2007, ss 102-115; CTA 2009, s 1273; CTA 2010, ss 55-61) i.e. those involving a company partner. Being a highly complex business structure, this is unlikely to be of concern for most owner-managers.

857 Loss relief is also available *inter alia* in respect of property losses (CTA 2010, s 62), non-trading loan relationship losses (CTA 2009, s 574; CTA 2010, s 99), non-trading losses on intangible fixed assets (CTA 2009, s 753) and other miscellaneous losses (CTA 2010, s 94). These are not considered for space saving reasons.

858 CTA 2010, s 37(3)(a).

(b) Losses can be carried-back against profits from other sources in the *previous year*;[859]

(c) Losses can be carried forward and set-off against profits in *future years*.[860]

The flexibility in loss offsetting is not as extensive as that offered to partners due to the fact that company losses cannot be offset against the individual (general income) of the owner-manager (director-shareholder); this reflects the separate and independent identity of the company afforded by both the general law and the law of taxation. It is also important to appreciate that, in the initial stages of business, it is likely that the company's only option will be to carry forward losses and offset them against future profits.[861] Accordingly, as a general rule, owner-managers with other sources of income,[862] that anticipate potential business losses, may be better placed to at least start in partnership, rather than incorporate from the outset. In this way, there is a reversal of fortune for the company owner-manager who is then locked into the more tax inefficient form. Here, there is an interesting contrast with profit regulation:

> [t]he tax system discourages risk-taking because profits and losses are treated asymmetrically: the government penalises successful projects (by taxing the profits) more than it cushions unsuccessful ones (through loss offsets, which are incomplete, especially for new businesses that fail).

---

859 CTA 2010, s 37(3)(b); Finance Act 2009, Sch 6, s 23. The trade must have been conducted on a commercial basis with a view to the realisation of profit. FA 2021, Sch 2 extended this period to three years for losses incurred in accounting periods with an end date between 1 April 2020 and 31 March 2022. Hayes and Newman (n 779) 26.5: 'There is no limit on the amount of trading losses that can be carried back to the preceding year, but, after that, the amount of loss that can be carried back to the earlier two years is capped. There is a cap of £2 million for all relevant accounting periods ending in the period 1 April 2020 to 31 March 2021 (financial year 2020) and a separate cap of £2 million for all relevant accounting periods ending in the period 1 April 2021 to 31 March 2022 (financial year 2021).'

860 CTA 2010, ss 45, 45A, 269A-269CN, 730E-730H. The position differs for pre/post 1 April 2017 losses. The latter are more flexible but subject to restrictions not in place pre-1 April 2017.

861 See Howard and Tallon (n 356), Chapter 1 for further discussion.

862 Recall that this is approximately 25% of the owner-managed business population, and the high failure rates in the early years of business.

The extent to which this is to be regarded as horizontally inequitable will very much depend on one's view as to whether the tax system should mirror the general legal recognition of the company as an entity separate from its owners (shareholders). Recall that the LLP simultaneously has a separate legal identity but attracts look-through taxation treatment that broadly disregards the existence of the LLP, so decoupling taxation and the general law is neither impossible nor necessarily an incoherent policy option. The OTS has previously considered a look-through approach to taxing the owner-managed company, but this option was ultimately shelved, with numerous concerns cited.[863] From a neutrality perspective, there is the potential for distortion; owner-managed businesses that have good economic reasons for incorporation (such as those discussed in Chapter 2), may hold off, and operate in partnership, due to concerns about potential losses in early years. Once more, this will generate a deadweight efficiency loss.

4.5.2 Retained Profits

In some instances, an individual may wish to effectively retain profits within the business i.e. rather than drawing profits down for personal use (discussed above), they continue to be ringfenced within the business – at least for another year.

> '[S]ome of those interviewed in the qualitative research [for the reasons Behind Incorporation Report] explained that they were drawing minimal income from the business due to the need to keep money in the business, or for other reasons such as not needing the money due to previous wealth or having other sources of income and therefore allowing them to keep as much money in the business as possible.'[864]

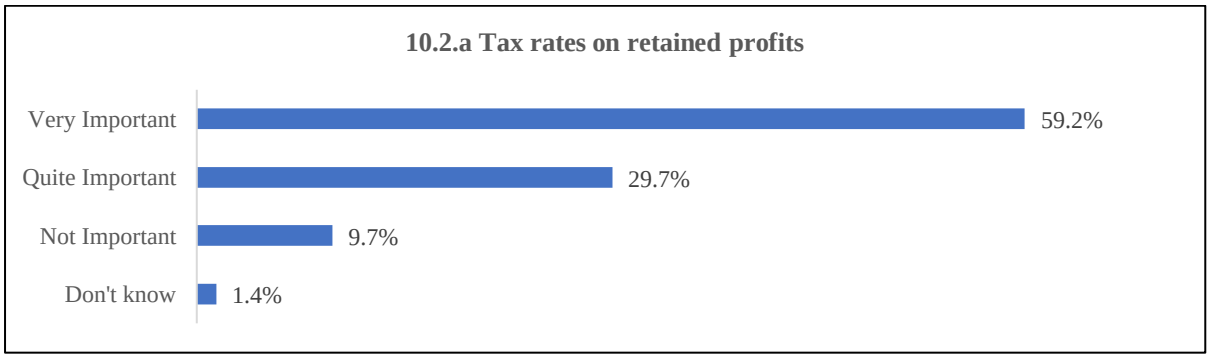
863 OTS Small Company Taxation Review (n 40) 13-16. See Annex E for further discussion.

864 HMRC Reasons Behind Incorporation (n 25) 49.

The de facto retention of profits within a partnership structure is a non-event for tax purposes. As previously explained, the look-through taxation treatment afforded to partnerships means that the profits (and losses) are treated as belonging to the individual partner, whether left in the business account or not. By way of comparison, the retention of profits within the company results in the profits only being subjected to corporation tax. Since the money is not paid out to the owner-manager(s), no income tax or NICs is [are] payable.

The author's survey asked respondents to indicate how important the applicable tax rates for retained profits are for owner-managers. 88.9%[865] stated that the matter was important – 59.2%[866] thought it 'very important' and 29.7% 'important'.[867] This ranked second in the list of tax considerations provided as part of the survey.

Figure 183: Respondents' view as to the importance of tax rates on retained profits for owner-managed businesses



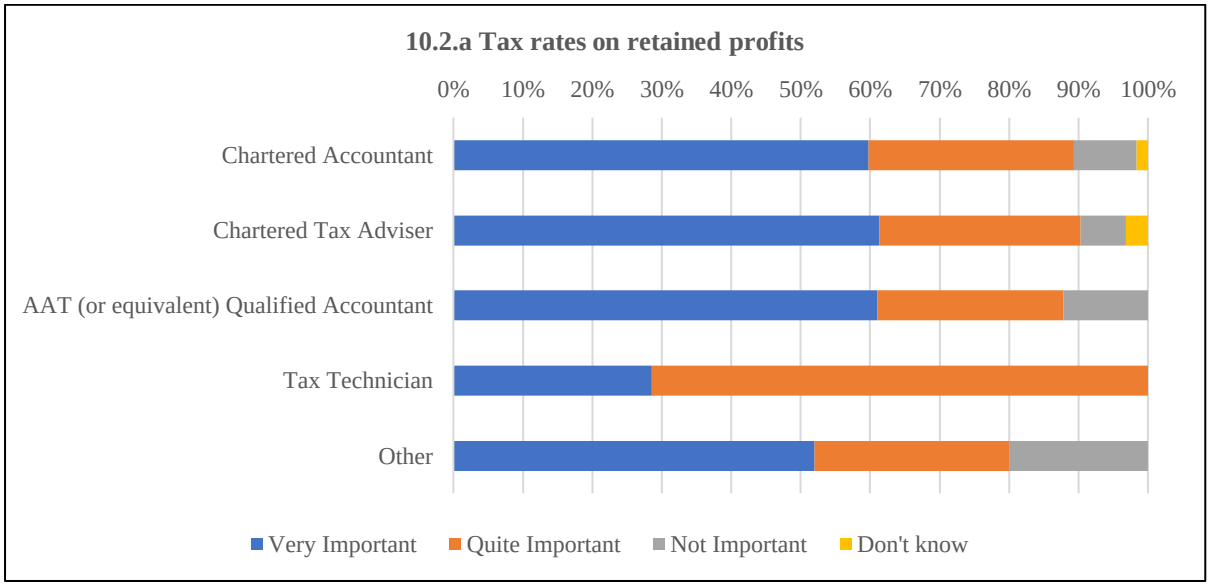
865 320/360.

866 213/360.

867 107/360.

Cross-tabulation by reference to qualification demonstrates up to a 20% variation in viewpoint upon the importance of the taxation of retained profits, with Tax Technicians (100%)[868] at the upper end, and 'Other' qualified respondents at the lower (80%).[869]

Figure 184: Respondents' view as to the importance of tax rates on retained profits for owner-managed businesses, by reference to qualification



100%[870] of respondents that had been advising for 1-5 years believed that the taxation of retained profits was an important consideration for owner-managed businesses. The percentages were lower in the other two categories – 83.9%[871] in the 6–10-year group reported that the matter was important to some extent, as did 88.4%[872] in the more than 10 years group – but there is no overall trend vis-à-vis length of time advising.

868 7/7.

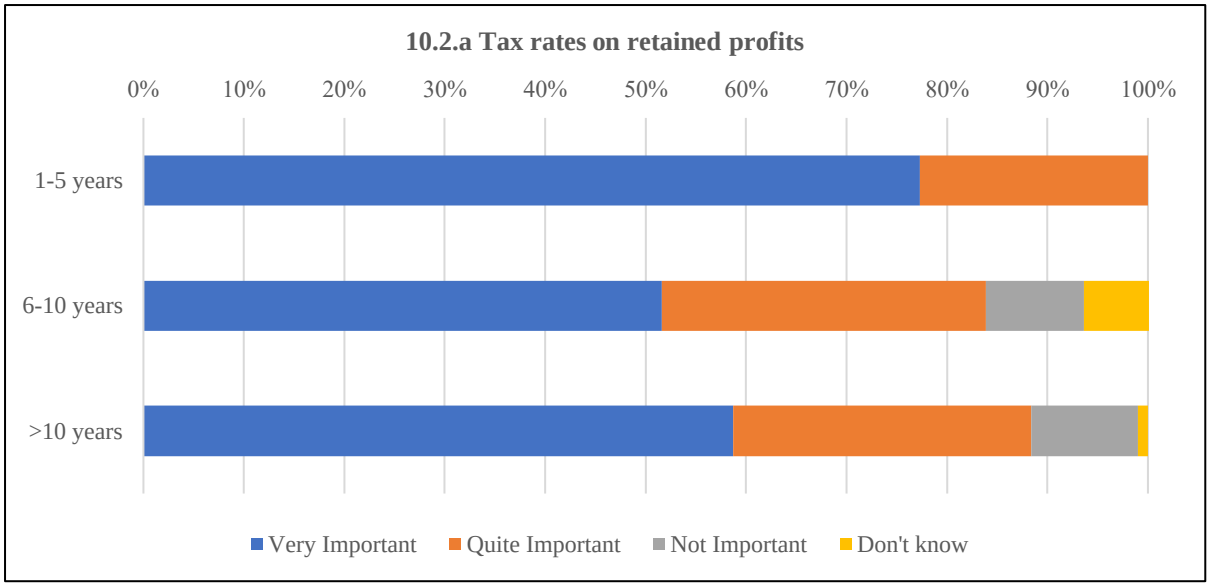
869 20/25.

870 22/22.

871 26/34.

872 268/303.

Figure 185: Respondents' view as to the importance of tax rates on retained profits for owner-managed businesses, by reference to experience



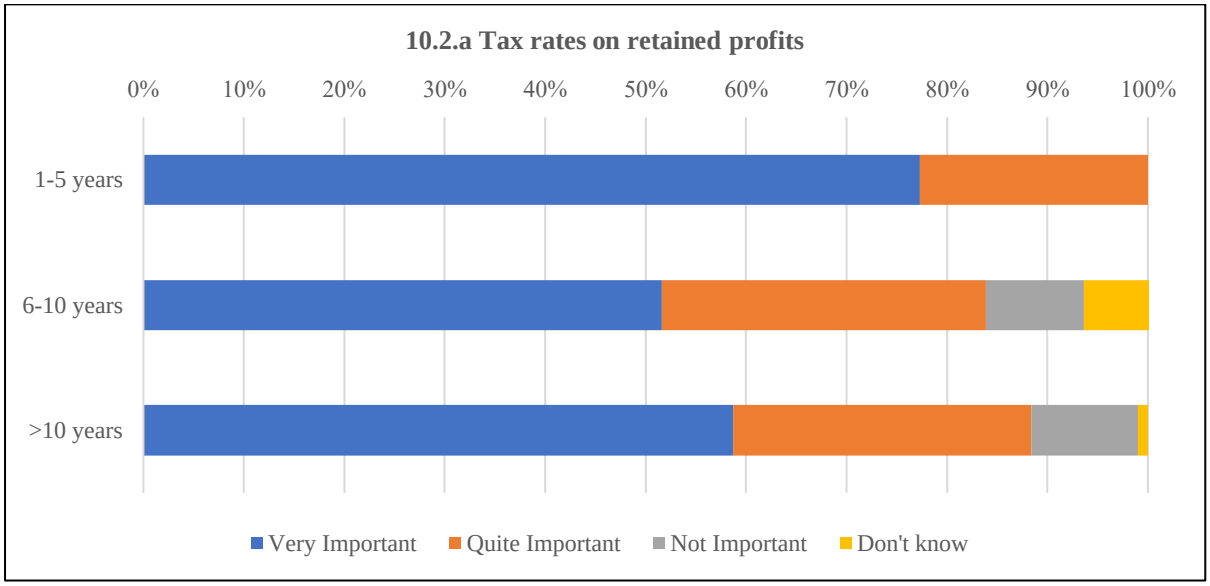
There are also opinion variations evident with cross-tabulation based on firm size. Respondents in the 11-20 category were the most likely to report (95.1%)[873] that the taxation rates applied to retained profits is important for owner-managed business, followed by the accountants in a firm size of 1-2 members (90.6%).[874] Respondents in the largest firms were less likely to think the matter important, though a large majority (85.7%)[875] nonetheless did.

873 39/41.

874 116/128.

875 36/42.

Figure 186: Respondents' view as to the importance of tax rates on retained profits for owner-managed businesses, by reference to firm size



Clearly, the ability of owner-managers to shelter profits within the company and thereby not have them subject to personal taxation offers a real advantage for those intending to reinvest and grow, and the author's research confirms that the taxation of retained profits is an important consideration for the owner-manager(s). The OTS has highlighted the differential position of partners as an area of concern since it impacts upon the ability of partners to maintain the business:

> [t]here is a significant business issue that we have heard regularly from partnerships and their representatives. That concerns profit retention… It is the nature of a partnership that profits are automatically allocated to the partners and the income tax system naturally proceeds to tax those profits. Some partnership agreements may provide for a certain element of profit retention for the purposes of meeting working capital requirements but this is difficult when partners are being taxed on income…this is clearly a major issue…[876]

876 OTS Partnerships Interim Report (n 33) 16.

Beyond meeting working capital requirements, Adam and Miller have questioned the extent to which retention is ever attributable to genuine investment and growth intent:

> [d]espite the significant amount of money that is retained within companies…there is no evidence that tax-motivated retention leads to higher investment in assets for use in the business; instead the earnings are held in cash or cash equivalents.[877]

The OTS Small Company Taxation Review also reported that most non-employing owner-managed businesses did not, on the whole, plan to grow.[878] This suggests that Adam and Miller are correct in that, at least the majority of owner-managed businesses are not truly investing when profits are ring-fenced within the company structure. Indeed, owner-managers utilising the company form may elect to leave money within the company (rather than have profits paid out by way of salary or dividends) with a view to facilitating income shifting, also known as income smoothing. This tax planning opportunity will be considered in Part 4.5.3 (immediately below). However, the current taxation system is evidently more favourable to the company in so far as profit retention is concerned (whatever the rationale may be).

4.5.3 Income Shifting

Income shifting relates to an individual's choice and ability to move income between different tax years. Where the owner-manager conducts business through a company, income shifting is made possible by the separate treatment of the company for tax purposes.

> Company owner-managers can use the ability to retain income in their companies to defer paying personal tax on it, to shift their income forwards or

877 Adam and Miller (n 664) 105.

878 OTS Small Company Taxation Review (n 40) 10.

> back in response to policy changes, and to smooth their taxable income (and therefore tax payments) over time. For example, a company owner-manager who usually earns less than the higher-rate income tax threshold but occasionally earns more than that can avoid paying any higher-rate income tax if she retains earnings in the company when she earns more than the threshold and takes them out in the year when she earns less.[879]

Miller, Pope and Smith report the following:[880]

> there are two main reasons why owner-managers may shift taxable income across time in response to changes in their marginal tax rate. First, to smooth out volatility in their total incomes, which allows them to avoid being penalised by the progressivity of the tax system if their total income fluctuates around the kink. Second, some owner-managers may systematically retain profits in their company in order to take advantage of lower tax rates in the future.

In some instances, partners do have the ability to shift and smooth profits across multiple tax years by making an 'averaging claim' (on a two- or five-year basis) under Part 2, Chapter 16, ITTOIA 2005. Where the election is available, the amount of profits for each tax year to which the claim relates is based on the average of the relevant profits for those tax years.[881] However, the extent of the relief is curtailed in several critical ways. Firstly, it is only available to taxpayers that have a 'qualifying trade, profession or trade' which is strictly limited to farming and the creative arts.[882] Secondly, it is not available to partners that have elected to use the cash basis for the calculation of profits.[883] Thirdly, the qualifying conditions for both two- and five-year averaging claims require a profit differential of at least 75% between tax

879 Adam and Miller (n 664) 102.

880 Helen Miller, Thomas Pope and Kate Smith, *Intertemporal Income Shifting and the Taxation of Owner-Managed Businesses*, Institute for Fiscal Studies, 2021. The authors of the study used linked personal and corporate administrative tax returns to assess the effects of marginal tax rates upon intertemporal income shifting activity by company owner-managers. The data covered all tax accounting period that finished in the tax years 2000-01 to 2014-15.

881 ITTOIA 2005, s 22(3)(3).

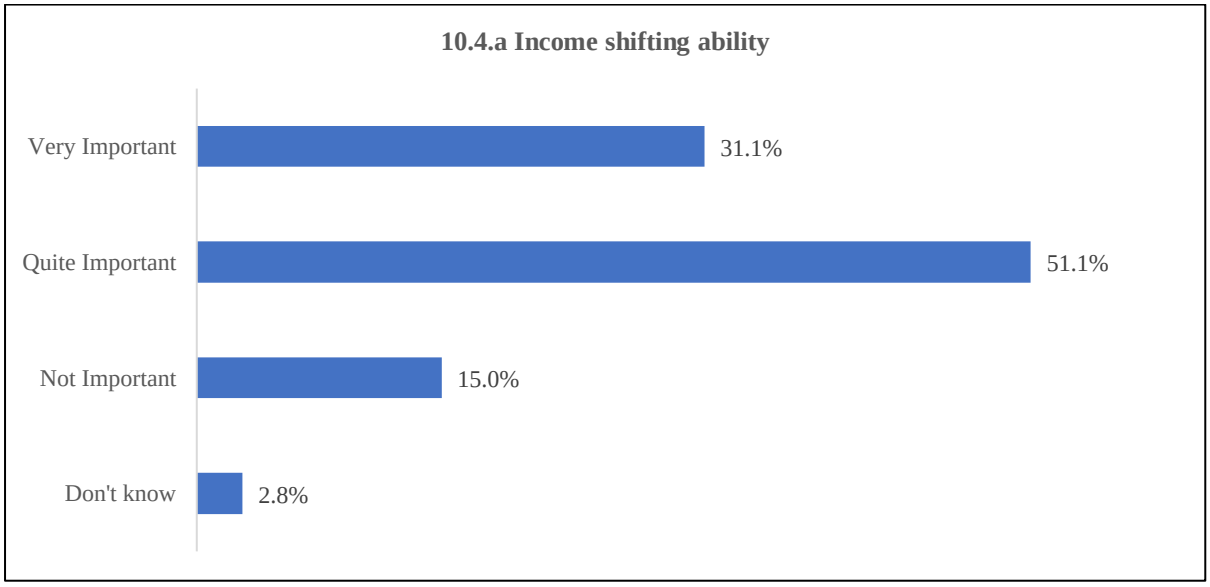
882 ITTOIA 2005, s 221.

883 ITTOIA 2005, s 221A.

years.[884] Due to such restrictions, the number of partners able to make averaging claims is highly limited, and the overall treatment is clearly less favourable than that afforded to company owner-managers that seek to smooth and shift income.

82.2%[885] of the respondents to the author's survey reported that the income shifting ability of owner-managers was an important consideration in the operation of business. This ranked fourth highest in the list of tax-based considerations offered as part of the survey and just 0.2% lower than the figure returned for the importance of NICs rates.

Figure 187: Respondents' view as to the importance of income shifting ability[886]



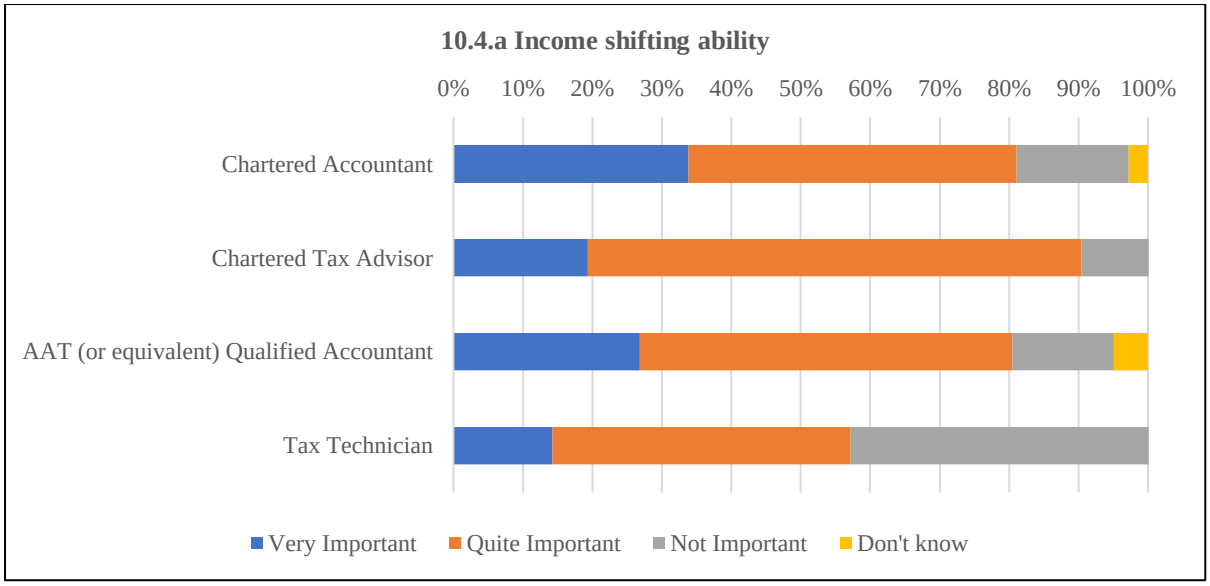
884 ITTOIA 2005, s 222-222A.

885 296/360.

886 Cross-tabulated data for experience has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Variations in opinion emerged between respondents possessing different types of qualification in relation to the income shifting point. Tax Technicians were substantially less likely to view the matter as important as compared to other respondents (just 57.2%).[887] Noteworthy is the fact that as between Tax Technicians and Chartered Tax Advisors (most likely to regard income shifting ability as important – 90.4%)[888] the percentage differential is as high as 33.2%.

Figure 188: Respondents' view as to the importance of income shifting ability, by reference to qualification



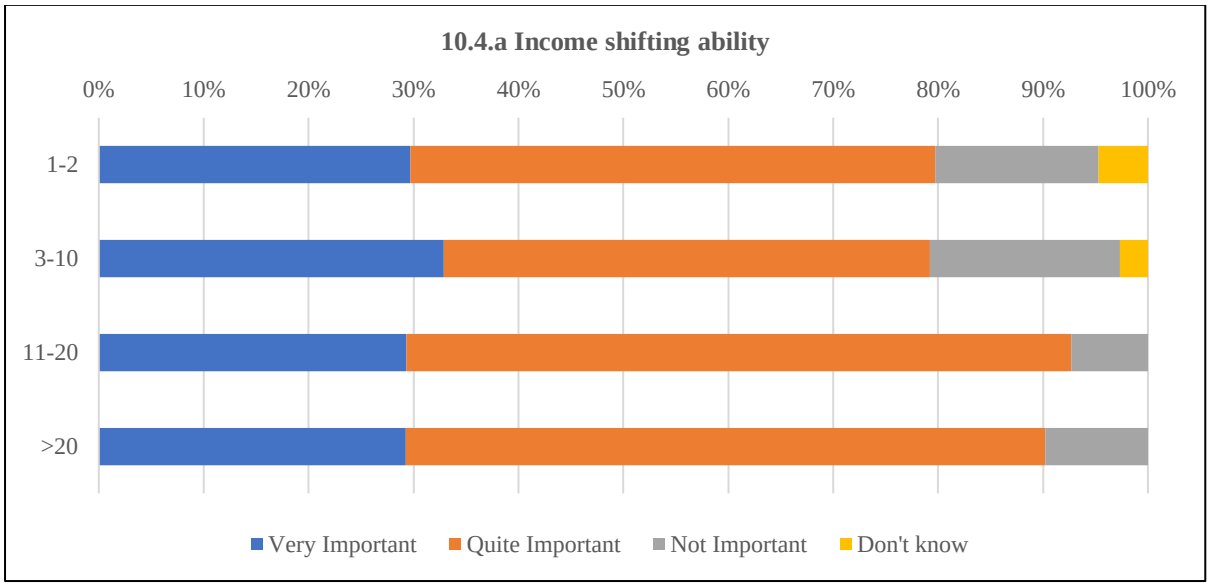
In addition, respondents in larger firms (11-20 and more than 20 accountants categories) were more likely to regard income shifting ability as important for owner-managers

887 4/7.

888 28/31.

(92.7%[889] and 90.3%[890] respectively), than those based in smaller entities (1-2 and 3-10 accountants per firm, returning figures of 79.7%[891] and 79.2%).[892]

Figure 189: Respondents' view as to the importance of income shifting ability, by reference to firm size



In terms of the incentives to income shift, Miller, Pope and Smith argue that there is a case to be made for enabling individuals to smooth an otherwise volatile income, whether the business is incorporated or not. This enables a more horizontally equitable tax treatment of like individuals, where the relevant time frame is greater than the tax year.

> Around half of the observed responsiveness of owner-managers' taxable income to the kink at the higher rate threshold can be attributed to intertemporal shifting that allows volatility in total income to be smoothed…in this case allowing individuals with volatile incomes to smooth out fluctuations means

889 38/41.

890 37/41.

891 102/128.

892 118/149.

> that they are not penalized by the progressivity of the tax system relative to someone with the same average, but stable income. Effectively, smoothing allows the tax system to better approximate the taxation of lifetime incomes… Income volatility is… high for these groups [of unincorporated businesses], such that there is a case for extending the ability to smooth taxable income. Allowing smoothing for all business owners would remove one form of distortion to the choice of legal form within the UK (i.e. those with more volatile incomes have an incentive to incorporate), although it would also be costly in terms of reduced government revenue and potentially add additional complexity.[893]

Whilst attempting to smooth a volatile income is one reason to engage in shifting activity: [894]

> the incentive to retain to shift income to the future exists for all owner-managers whose average total income exceeds the higher rate threshold: many more owner-managers with average total incomes above a threshold retain substantial amounts, even if they are not 'fully retaining'… Above the threshold (approximately £40,000) the amounts retained are large and increasing.

The different incentives produce different results for the purposes of economic analysis and compliance with the basic principles of good tax design: [895]

> [a]ccounting for both the presence and nature of intertemporal income shifting is important for calculating the efficiency costs of taxing company owner-managers; the estimated deadweight loss associated with a marginal increase in personal taxes decreases by around 80% once we account for income shifting… the shifting that business owners do in order to smooth income that fluctuates around a tax kink is costless (or close to it) and therefore unlikely to create large efficiency losses… the systematic retention of income within closely held companies in order to access a lower tax rates in future does create efficiency losses, through inducing business owners to delay their consumption.

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893 Miller, Pope, Smith (n 880) 40-41.

894 Miller, Pope, Smith (n 880) 35.

895 Miller, Pope, Smith (n 880) 44.

The resultant effect of the rules is that in relation to income shifting, which has been identified as important in the author's survey, is that the partnership is comparatively tax inefficient in two different ways. Firstly, there are limited opportunities for partners to smooth volatile income across tax years. In the interests of equity and neutrality, there is a reasonable case to be made for increasing the income smoothing ability of partners; doing so enables parity of treatment not only between partners and company owner-managers, but also partners and employees (who are more likely to have a 'smooth income' where the same amount of money is earned/generated over a longer-term period). Secondly, partners cannot derive a benefit by accessing lower tax rates from the 'systematic retention of income'[896] within the business. Given that this form of activity generates efficiency losses, widening access is a questionable policy choice, but whilst the differential treatment exists, the partnership form is destined to be less attractive; horizontal equity and neutrality will be compromised.

4.5.4 CGT Planning

Before addressing the detailed treatment of partnerships and company owner-managers under the CGT regime, it is important to appreciate that partnerships are unusual from a capital gains perspective in that their treatment is primarily regulated by a HMRC Statement of Practice, specifically SP D12;[897] though this does not have the force of the law, it provides a basis for

896 Miller, Pope, Smith (n 880) 44.

897 HM Revenue & Customs, Statement of Practice D12: Partnerships, 14 September 2015 <https://www.gov.uk/government/publications/statement-of-practice-d12/statement-of-practice-d12> accessed 19 April 2022. OTS Partnerships Interim Report (n 33) 48-50: 'This statement of practice was originally issued by the then Commissioners of the Inland Revenue on 17 January 1975. There had already been discussions with the Law Society and the Allied Accountancy Bodies on the CGT treatment of partnerships. This action was somewhat unusual as consultation on taxation matters was nowhere near as common as it is today. The purpose of the statement was to elucidate some issues of general practice which were evolving between the Inland Revenue and the professional bodies. The purpose of the statement was to set down the agreed practice in dealing with section 59… The statement has remained in place, largely unchanged ever since 1975. There are many people who cannot believe than an important area of taxation is governed almost entirely by a statement of practice which is almost 40 years old…'.

the regulation of the treatment of capital gains by HMRC. This can have unsatisfactory consequences, particularly in relation to comprehension of CGT itself.[898] Ambiguity in the provisions also gives rise to uncertainty.

> A common theme of many stakeholders comments, statistics, published commentaries etc is that no-one understands capital gains tax (CGT) in relation to partnerships…
>
> There is very little legislation to be found on how the members of partnerships are meant to be taxed on their capital gains. The fundamental legislation is currently stated in s59 Taxation of Chargeable Gains Act 1992 (TCGA 1992). This is brief almost to the point of confusion. It remains unclear what exactly the phrase in sub (1)(a): "tax in respect of chargeable gains accruing to them on the disposal of partnership assets shall…be assessed and charged on them separately" might mean. For example, it has been suggested to the OTS that this could be interpreted as meaning that the whole of the partnership gains could be charged to each partner…[899]
>
> They [i.e. partners] may be unaware of the mechanism by which capital gains are to be returned and taxed…HMRC in particular noted that it can be difficult to recognise when capital gains have arisen. Return Schedule SA803 only asks for a description of the asset and the gross proceeds. From this, HMRC partnerships processing or compliance have no idea whether a gain has arisen at all, let alone the amount of it. Different gains may arise to different partners owing to length of ownership of the asset in question and different acquisition costs….'[900]

As previously noted, companies are subject to only corporation tax, and not CGT (though capital gains are taxed under the corporation tax regime, currently at a rate of 19% assuming that no relief is available).[901] There are numerous points during the business lifecycle

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> Neither HMRC or practitioners seem enthusiastic about this possibility [of introducing new legislation to replace SP D12] and the statement would be extremely complicated to legislate.

898 The complexities are far too numerous to discuss at length, but these are covered comprehensively in Karen McNicholls, *Ray: Partnership Taxation* (Lexis Nexis: Online Subscription), Chapter 14.

899 OTS Partnerships Interim Report (n 33) 47. Note also that an LLP that has no trade or business is taxed on any gains that are realised as if it were a corporation (LLP Act 2000, s 10; TCGA 1992, s 59A).

900 OTS Partnerships Interim Report (n 33) 52.

901 CTA 2009, s 4.

where CGT (or the taxation of capital under the corporation tax regime) will be a relevant consideration. The principal 'key life events' for the typical owner-managed business can be identified as:[902]

- Starting up;
- Incorporation (where separate from the above);
- Operating the business;
- Succession (in the case of successful businesses);
- Disposal or cessation of the business.

Given the potential impact of CGT in the above instances, the author's survey questioned the extent to which CGT planning is an important consideration for owner-managed businesses, though this was non-specific to the above events.[903] 75.5%[904] of the respondents believed it to be important. The percentage of respondents reporting CGT planning as important increased with greater levels of experience (Figure 192)[905] and increased firm size (Figure 193).[906] The differences in opinion evidenced by cross-tabulation of the data based on qualification are relatively marginal, with the exception of Tax Technicians as the stand-out category (only 57.2%[907] believed that CGT planning is important compared to a mean average of 78.7% across the other qualification groups) (Figure 191).

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902 An amended version of the list from the OTS Business Lifecycle Report (n 73) 13.

903 This was with a view to ensuring that the survey was not too long for respondents to be willing to engage with it.

904 271/359.

905 +9.6% difference between the 1-5 years and >10 years categories.

906 +13.3% difference between the 1-2 and >20 categories.

907 4/7.

Figure 190: Respondents' view as to the importance of CGT planning

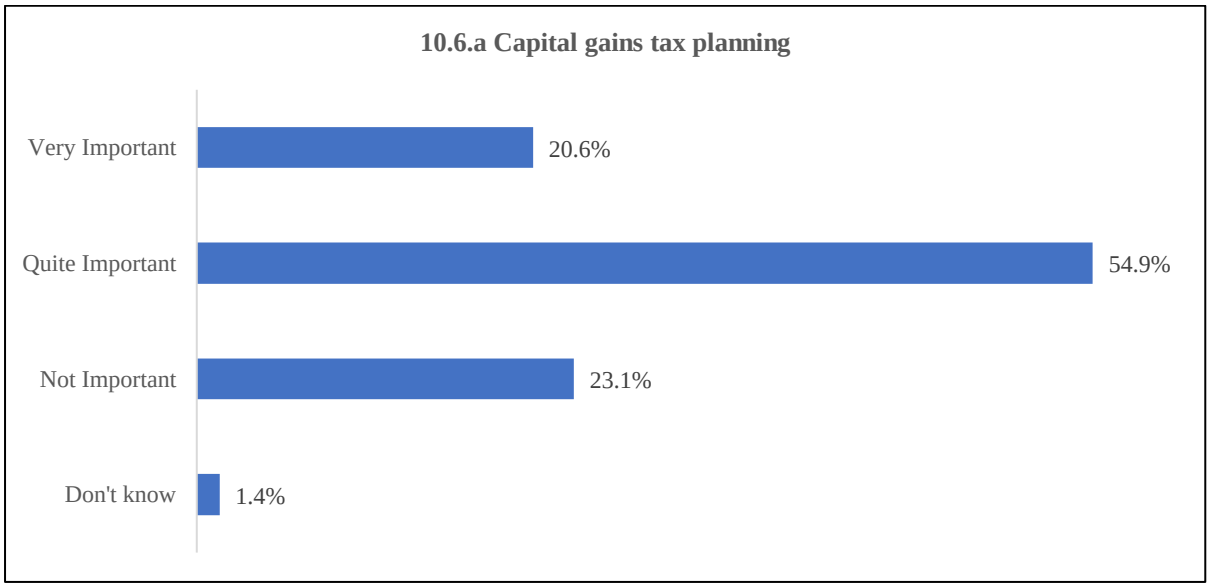


Figure 191: Respondents' view as to the importance of CGT planning, by reference to qualification

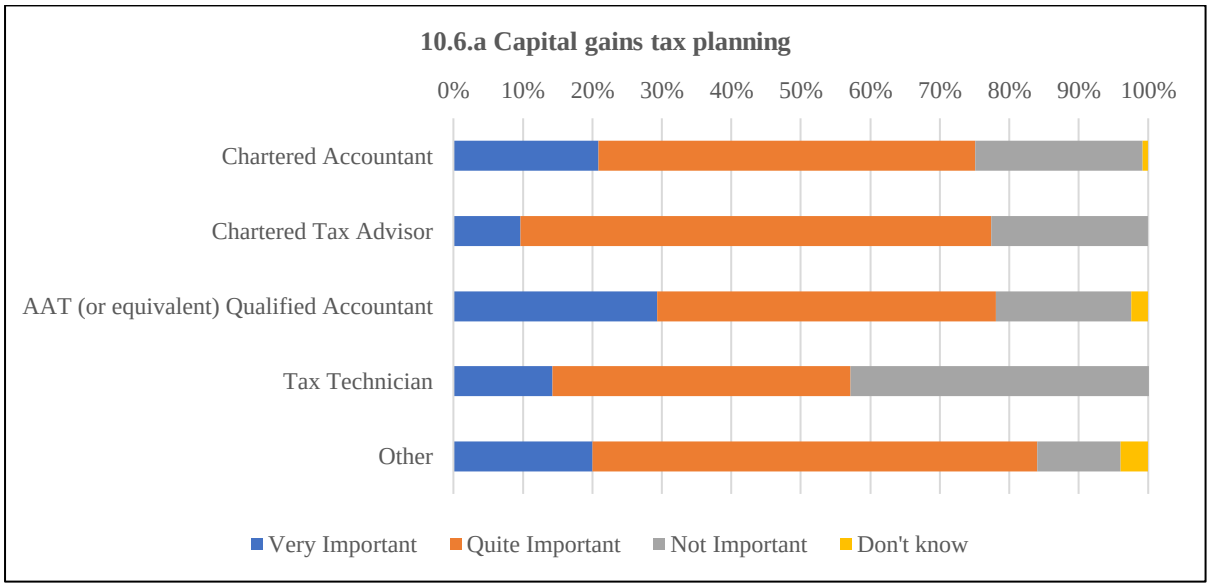


Figure 192: Respondents' view as to the importance of CGT planning, by reference to experience

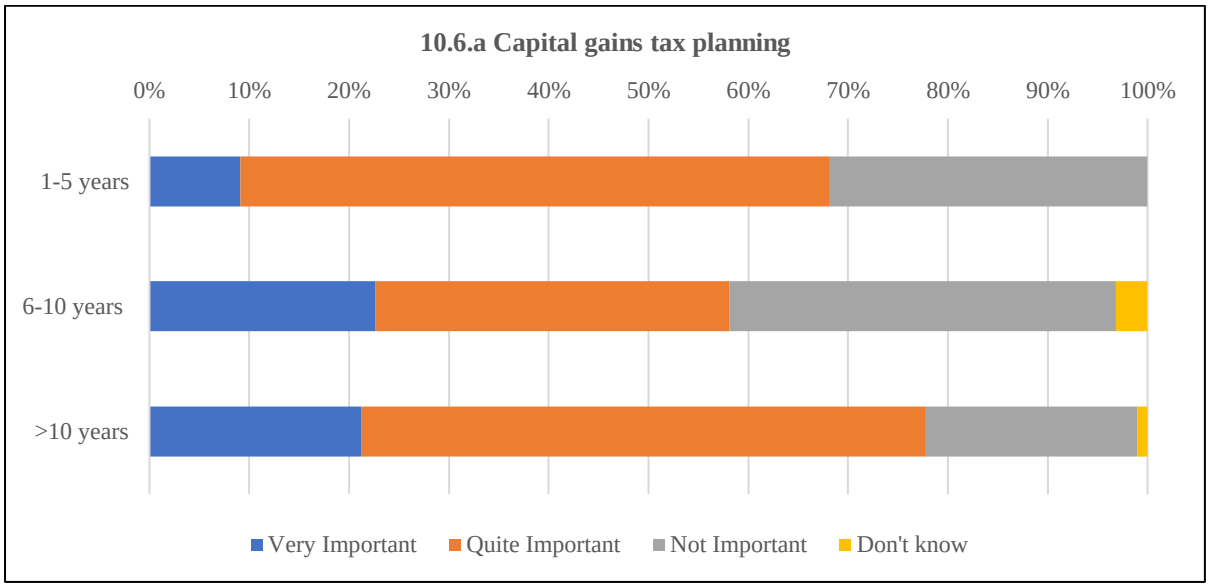
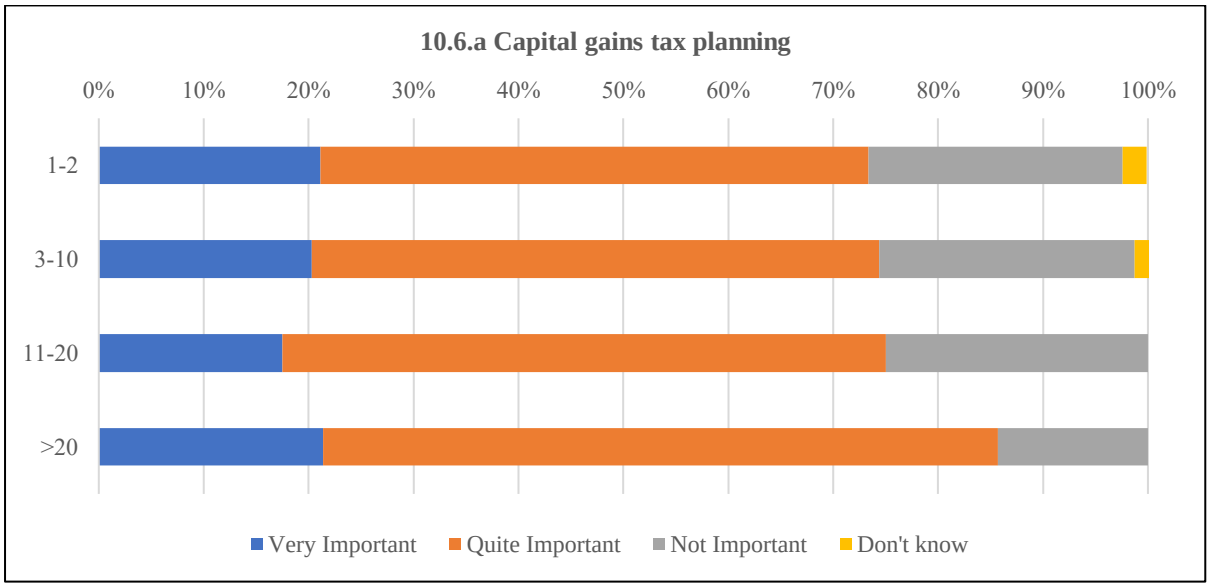


Figure 193: Respondents' view as to the importance of CGT planning, by reference to firm size



Any capital contributions by the owner-managers to the partnership at the inception of business will generate a liability to pay CGT to the extent that the gain is over and above the

annual exempt allowance (£12,300 in 2021-22);[908] the applicable rates in 2021-22 thereafter are 10% for a basic rate taxpayer, and 20% for additional/higher rate taxpayers, unless relief is available.[909] Note that if the asset is jointly owned by the individuals who form the partnership, then so long as the capital shares in the partnership reflect the prior ownership of the asset there will be no capital gain in relation to the asset. Furthermore, any transfers of personal (non-business) assets between spouses and civil partners that are living together at the time of the disposition will be treated as taking place on a nil loss, nil gain basis, meaning that no CGT is due.[910] OTS research suggests that the vast majority of owner-managed partnerships will not acquire capital assets; any assets used as part of the business are generally owned by the individual outside of the partnership, so this will not be of concern to a significant number of owner-managers intending to operate as partners.[911] Where there are capital contributions by the partners, the position is regulated by paragraph 5 SP D12:

> 5.2. Where an asset is transferred to a partnership by means of a capital contribution, the partner in question has made a part disposal of the asset equal to the fractional share that passes to the other partners. The market value rule

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908 TCGA 1992, s 1K(2)-(5). This may be deducted from gains in whatever way is most beneficial to a person chargeable to CGT (irrespective of the rate of tax at which the gains would otherwise have been charged).

909 TCGA 1992, s 1H(3). Higher rates are charged on the disposal of residential property and carried interest gains – 18% and 28% (TCGA 1992, S 1H(2)).

910 TCGA 1992, s 58.

911 OTS Partnerships Interim Report (n 33) 47. The partners should be cautioned against the possible deeming effect of PA 1890, s 20(1) if there is any ambiguity as to whether assets used in the partnership are partnership property: 'All property and rights and interests in property originally brought into the partnership stock or acquired, whether by purchase or otherwise, on account of the firm, or for the purposes and in the course of the partnership business, are called in this Act partnership property, and must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement.'

When a partner lets assets to a trading or professional partnership of which they are a member, then provided they are used for the purposes of the trade or profession then CGT relief will be available under TCGA 1992, s 152. HM Revenue & Customs Statement of Practice D11, 31 March 1978 <https://www.gov.uk/government/publications/statement-of-practice-d11/statement-of-practice-d11> accessed 3 April 2022.

> applies if the transfer is between connected persons or is other than by a bargain at arm's length…

In the event that partners choose to incorporate the existing business, a CGT liability is technically triggered, which would be treated as taking place at market value on the basis that the parties to the transaction will be connected persons.[912] However, roll-over relief will likely be available, which has the effect of postponing the CGT otherwise due until the shares in the company are subsequently disposed of.[913] In order to qualify for the relief, the business must be transferred as a going concern together with all its assets, in return for an issue of shares in the transferee company.[914] The relief is intended to facilitate incorporation, by making the event tax neutral for the owner-manager, though if consideration other than shares is received, CGT will be payable. The relief is automatically available and need not be claimed. In this respect, the act of incorporation alone leaves little room for any serious CGT planning activity (beyond being careful about the receipt of consideration which is not shares) and does not therefore generate any concerns from a principled perspective – the asymmetry with disincorporation does (see Chapter 5).

If the incorporation is not in succession to a pre-existing trade or profession, and there is a transfer of a chargeable asset by the owner-manager to their company, a CGT charge will

912 TCGA 1992, ss 17-18, 286.

Inheritance Tax should not be an issue here, at least not immediately. If the asset has previously been used as a business asset, then BPR ought to apply (Inheritance Tax Act 1984 ("**IHTA 1984**"), s 104). If the asset is a personal asset, then the gift is a potentially exempt transfer (IHTA 1984, s 3A). If the property was jointly owned by the individuals that form the partnership then there is no transfer of value (IHTA 1984, s 3).

913 TCGA 1992, s 162.

914 TCGA 1992, s 162.

arise based upon the market value of the asset.[915] A company is connected with another person if that person has control of the company or persons connected with them together have control of it – this rule will be applicable to company owner-managers.[916]As with partnerships, the majority of owner-managed companies will not need to receive large transfers of capital assets at the inception of business (property businesses perhaps being the key exception here, where there will be SDLT to consider). The annual exempt allowance may suffice to ensure that CGT is not payable by most transferring owner-managers.

In short, CGT charges may arise, and need to be considered, at the inception of business in two situations. Firstly, where there is the formation of a partnership, and the partners deem a transfer of capital assets as necessary for business (which would be unusual), where the partners are not spouses or civil partners e.g. mother-daughter configurations. Secondly, where there is the formation of a company, and the company owner-managers deem a transfer of capital assets as necessary for business (also not the core case). The partnership may be the

915 OTS Business Lifecycle Report (n 73) 13: 'The absence of any immediate tax relief for the capital contributed by the start-up owner contrasts sharply with the plethora of tax reliefs that are available to subsequent investors.

There is also a potential IHT trap here. See IHTA 1984, ss 1, 3, 3A. Mark McLaughlin, Tax Insider, February 2019 <https://www.taxinsider.co.uk/gifts-to-and-from-a-company-don-t-forget-iht-ta> accessed 30 March 2022: 'A transfer of value (e.g. a lifetime gift) from an individual to a company is an immediately chargeable transfer for IHT purposes, subject to any available exemptions and/or reliefs (by contrast, a gift to another individual is a potentially exempt transfer ["**PET**"], which becomes exempt from IHT if the donor survives at least 7 years). A chargeable lifetime transfer to the company in excess of the individual's available nil rate band [£325,000 for 2021-22] is liable to IHT at 20%, and further IHT may become due if the donor dies within seven years. The IHT charge (if any) is based on the reduction in value of the individual's estate as a result of making the gift. In an owner-managed or family company where the individual making the gift is a shareholder, this reduction may be offset to the extent of any increase in the value of the individual's company's shares resulting from the gifted asset.' Another way to avoid this might be to ensure that the company provides adequate consideration for the transfer, though the owner-manager will need to be able to prove that the transaction was not intended to confer a gratuitous benefit *on any person* (including the other owner-manager, which may be difficult to establish) and the transaction was such as might be expected to be made in a transaction at arm's length between persons not connected with each other (this may be difficult where the only consideration is a credit in the director's loan account); IHTA 1984, s 10.

916 TCGA 1992, s 286(7). See also TCGA 1992, ss 17-18.

beneficial form where inter-spousal capital transfers are anticipated. Where incorporation is desirable (ideally for sound non-tax reasons), starting as a partnership would enable the owner-managers to take advantage of section 162 TCGA 1992 roll-over relief to avoid generating a CGT for the transfer of assets associated with incorporation. However, given the high rate of entry-exit rates for owner-managed businesses, and the declining number of overall partnerships, this strategy (partnership first-incorporate later) does not appear to be a common one; if it were, the numbers of partnerships would at least be broadly stable, and possibly increasing, considering the increase in owner-managed company population. Accordingly, this aspect of CGT does not appear to be impacting upon the decision to incorporate (or not). This supports the general notion that the majority of owner-managers do not transfer high-value (if any) capital assets when starting out in business but may also reflect the general lack of understanding as to how CGT applies to partners, and people intending to operate in partnership.

Note that the above rules continue to apply for any personal transfers to the partnership and company throughout the course of business. At a general level, sales of partnership and company assets throughout the course of business should be reasonably simple, and the applicable principles are the same. In respect of partners, 'the gain can be…divided between the partners. Each partner then bears CGT on his or her proportionate share… (HMRC note that this approach is not supported by statute).'[917] Roll-over relief will be available on disposals of business assets where new business assets are acquired in consideration of the disposal (beginning with the period 12 months before the disposal and ending three years after the

[917] OTS Partnerships Interim Report (n 33) 47. The statute suggesting that each partner may be liable for the whole.

disposal, unless HMRC agrees an extension of time).[918] The lower CGT rates applicable to basic rate taxpayers (10% in 2021-22), and the existence of a personal allowance (£12,300 in 2021-22), mean that from a CGT perspective basic rate taxpayers would be better placed to operate as partners, rather than company owner-managers. The break point will be the crossing of the threshold into the higher rate tax band, where gains exceed the annual exempt amount. However, the apparent lack of large capital transactions for most owner-managed businesses suggests that this will be highly unlikely to influence the decision to select one business form (the partnership) over the other (company).

The separation of the company from its owner-managers for tax purposes enables individuals effectively to convert what might otherwise be taxable income into capital gains that are subsequently realised upon the sale of shares or dissolution of the company (this opportunity therefore affects decisions made whilst operating the business). Upon disposal or dissolution, the capital gains are calculated by reference to the difference between the current value of the shares (including net assets and retained earnings) and the value of the shares when the company was incorporated by the owner-manager. This is incentivised by the general tendency (in recent years) to tax capital gains more lightly than income, particularly above higher rate thresholds.[919] Furthermore, the CGT allowance is, at present, significantly higher than the dividend allowance (whereby dividends are the only type of income subject to a

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[918] TCGA 1992, ss 152-159A. Note that the asset does not have to be of the same class as the one disposed of.

However, if the new asset is a depreciating asset with a predictable life of 60 years or less there is no roll-over relief available. Instead, there is hold-over relief under TCGA 1992, s 154. Liability to pay the CGT charge (calculated at the time of actual disposal) crystalises on the earlier if the following events: (i) when the new asset is disposed of; (ii) ceases to be used in the business, or; (iii) upon the 10th anniversary of the acquisition of the replacement asset.

[919] Recall that in 2021-22 higher rate income taxpayers are subject to a 45% income tax rate. Capital gains are taxed (in principle) at 20% or 28% if property, though as explained below this will often be reduced to 10% by way of BADR: TCGA 1992, s 169H-169V.

comparative preferential rate for basic rate taxpayers).[920] It is also available in addition to the income tax personal allowance, meaning that even basic rate taxpayers may find the conversion of income to capital attractive. In essence, this is another form of income shifting, though perhaps more accurately described as income converting.

Above the basic rate threshold, the position is exaggerated by the availability of BADR[921] (formerly Entrepreneur's Relief).[922] It is widely accessible to many company owner-managers,[923] though the company ('personal company') must have been trading for at least 2 years prior to the disposal, and the individual must have been an officer or employee for the same period.[924] Three free text responses to the author's survey referenced the importance of Entrepreneur's Relief. The matter was summarised by Miller, Pope and Smith in their research into intertemporal income shifting:

> '[lighter taxation of capital gains under the Business Asset Disposal Relief regime] provides an incentive for owner-managers of companies with total

920 £12,300 CGT allowance as compared to the £2,000 dividend allowance. Prior to 2016, the tax treatment of dividends for basic rate taxpayers would have encouraged the payment of dividends rather than conversion to capital gains.

921 TCGA 1992, s 169H-169V.

922 OTS Small Company Taxation Review (n 40) 50: '[w]e heard that the title "entrepreneurs' relief" is not considered to be about entrepreneurship at all, coming at a time when the individual is exiting the company. Our sense is that there is merit in a proper study of the effectiveness of entrepreneurs' relief.'

923 The full conditions are set out in TCGA 1992, s 169I. Whilst TCGA 1992, s 169I(6) refers to a 'trading company' the relief is not strictly limited to trades. TCGA 1992, s 165A(3): '"Trading company" means a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities.' s 165A(4): '"trading activities" means activities carried on by the company – (a) in the course of, or for the purposes of, a trade being carried on by it…'. s 165A(14) 'In this section - …"trade" means (subject to section 241(3) [furnished holiday lettings]) anything which – (a) is a trade, profession or vocation, within the meaning of the Income Tax Acts, and (b) is conducted on a commercial basis and with a view to the realisation of profits.' The relief will not therefore apply to the sale of shares in companies that engage in any substantial investment activity.

924 There are also references to trading groups, but this is beyond the scope of consideration for owner-managed businesses.

> income above the higher rate threshold to retain profits in the company and to withdraw it as capital gains upon sale or dissolution. [925]

Consequently, this 'exacerbates the difference between the taxation of labour and capital for precisely the group that has the greatest ability to switch their income between labour and capital tax bases.'[926] Adam and Miller have correctly highlighted that the revenue cost is also significant:

> [i]n 2017-18 (the last year for which we have data on the number of claimants), the estimated cost of entrepreneurs' relief was £2.3 billion, or £53,500 per claimant. Note that this tax advantage will typically relate to capital gains built up over many years (it is not the tax saving made each year by a claimant) and is the cost relative to a case in which these gains are taxed under the main capital gains tax regime.[927]

For owner-managers accessing the preferential (10%) rate of CGT 'mean capital gains are £500,000, corresponding to a tax saving (relative to taxation on accrual) of £75,000 over the company's life.'[928] Whilst it is correct to say that BADR is also available to partners, it does not facilitate income conversion in the same way as for company owner-managers - this is impossible because partners are taxed on income as it arises. The tax planning opportunity is simply not present. The CGT treatment of converted income therefore perpetuates the horizontal inequity previously identified, thereby further breaching the principle of business form neutrality.

925 (n 880) 19.

926 Cribb, Miller and Pope (n 4) 6-8.

927 Adam and Miller (n 664) 10.

928 Miller, Pope and Smith (n 880) 7.

As discussed in Chapter 2, succession planning is a matter that may be considered by some forward-planning owner-managers from the business inception, but this is unlikely to be the case for the majority. The existence of a relationship between succession planning and possibly tax-motivated incorporation is questionable, but to the extent that it may be a driver for some, the complexity in application of SP D12 to partnerships in succession matters is concerning. According to the OTS:

> [s]ome commentators have disagreed with HMRC over how capital gains should be calculated in circumstances to which the terms of SP D12 apply… A typical problem might revolve around a father to son transfer in some way e.g. son is taken in to partnership. The son thus gets some goodwill but what is the value? Should there be some sort of rollover to recognise that no cash changed hands?
>
> So far, informal settlements have been reached with HMRC…If any issue is taken to litigation, the Courts will interpret the legislation itself. As that is minimal, no one seems to know what view will be taken. Hence there is a reluctance to press the issue for the time being…[929]

Cory's advice suggests that the problems are not insurmountable, but care should be taken as to the mode of succession:

> [t]he extent to which this [CGT] can cause problems depends on the terms on which the children are admitted to partnership. The general rule is that where a person is admitted as a partner without payment of consideration HMRC will accept that the value of the obligations undertaken by a new partner is adequate consideration for the interest that he acquires in the partnership assets. This general principle does not necessarily apply where the incoming partner is a connected person, for example, where a son is brought into a partnership with his father. However, in such circumstances the transfer of the partnership interest to the son will be regarded as having been made for full market value if it can be shown that no payment would have been required had the parties been at arm's length. In other words there will not be a disposal by the father for capital gains tax purposes if it can be demonstrated that the son was brought into the partnership on arm's length terms. In many types of business,

[929] OTS Partnerships Interim Report (n 33) 48-50.

> particularly the professions, an incoming partner would not be expected to make a payment for goodwill or to acquire an interest in other partnership assets as the work that he will do in the partnership business would be regarded as full consideration. Where an arm's length partner might be expected to make a contribution because, for example, there are valuable business assets other than goodwill, it may be possible to avoid a capital gains tax disposal by providing in the partnership deed that the father is to remain entitled to the whole or a major part of such assets. In any event any liability can be avoided by an election under TCGA 1992, s 165 [relief for gifts of business assets]...
>
> Obviously, the reason that there is no capital gains tax disposal in such circumstances is that the father has given up nothing as the son's activities in the business are necessary to maintain the existing value of the business. The next step would, therefore, be for the son's share of the business to increase and his father's to reduce. In many cases it should again be possible to do this without creating a tax charge provided that care is taken to ensure that changes in profit sharing ratios are on commercial terms. For example, in any partnership a new partner might expect to start with a relatively low profit share and to increase this as he became more established and either takes on more responsibility or generates a greater share of the partnership profits. Accordingly, once the son has been a partner for two or three years it would be reasonable to start gradually increasing his share up to 50% in very many types of business, as an arm's length partner would expect to become an equal partner over a period of perhaps ten years.[930]

However, gifts of the partnership assets (being the share in the partnership, so to speak)[931] may qualify for BADR, whereby the applicable CGT rate would only be 10%. This will be applicable where the business is a trading business – conducted on a commercial basis with a view to the realisation of profits – and the partner has been operating as such for at least two years prior to the date of disposal (gift).[932] As previously noted, BADR is also available in relation to the disposal of company shares.

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930 David Cory, 'Passing on the Family Business' in Rebecca Forster, *Tolley's Tax Planning 2021*-22 (Lexis Nexis 2021) 46.11.

931 TCGA 1992, s 169(I)(8)(c) provides that 'at any time when a business is carried on in partnership the business is to be treated as owned by each individual who is at that time a member of the partnership.'

Note that it is possible to admit an individual as a partner but provide as part of the partnership agreement that the admission does not entitle the new partner to any share of the capital assets. This would avoid a disposal from taking place.

932 TCGA 1992, s 169I(3).

As indicated by Cory, a more favourable hold-over relief is available upon gifts of business assets (which will often be the case where there is succession in the family business),[933] which includes assets held or used by the partnership, as well as shares in personal companies.[934] A CGT liability will be triggered in the event that actual consideration is received which exceeds the value of any permissible deductions.[935] Both the transferor and the transferee will need to make an election for the relief to be claimed.[936]

The availability of both BADR and Gift Hold-over Relief to partners and company owner-managers alike means that there are no significant tax advantages to be gained in succession planning by selecting one form over another. Broadly, in respect of successions, the CGT implications are the same, though the complicated application of SP D12 may make the partnership less attractive from an administrative and compliance perspective. Accordingly, the primary gain to be made from CGT planning for most owner-managers lies with the ability to convert income to capital gains via the company structure.

933 TCGA 1992, s 165.

Note however, that if the gift is an immediately chargeable transfer (not a PET) for inheritance tax purposes then relief is provided by way of TCGA 1992, s 260 instead (this provision has priority over s 165). In most cases, the gift will be a potentially exempt transfer under IHTA 1984, s 3A - s 260 applies in the event that there is a gift into trust.

934 TCGA 1992, s 165(2).

935 TCGA 1992, s 165(7). Deductions are regulated by TCGA 1992, s 38 which covers acquisition, enhancement, and disposal costs.

936 TCGA 1992, s 165(1)(a).

4.5.5 Pension Planning

Closely linked to taxation issues directly affecting the operation of the business, is the matter of pension provision for the owner-managers.[937]

> If an owner-manager is willing to delay taking income then an alternative, tax advantaged option is pension saving. For an owner-manager who expects to be a basic rate income taxpayer in retirement, this form of remuneration attracts the least tax. It does however come at the cost of inflexibility…pension pots can only be accessed when the individual reaches 55 years of age.

From an economic perspective:

> …the desirability of an entrepreneur setting aside substantial sums at an early stage into a pension scheme is of particular importance in the case of the family business. On retirement the entrepreneur will have three basic needs. He will not want to suffer a significant drop in his standard of living after retirement, he will want to be happy that his widow can maintain her standard of living after his death, and he will want to feel that he has capital to do some of the things that he did not have time to do during his working life...[938]

A partner has no real alternative than to make contributions to a personal pension plan ("**PPP**"), though the self-invested personal pension plan ("**SIPP**") offers a little more flexibility. Such contributions are subject to both annual and lifetime limits.[939]

> Incorporation opens up different possibilities in terms of pension provision. There is the opportunity to move away from personal provision and into the

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937 This was highlighted by two respondents in the free text responses to the tax section of the author's survey.

938 Cory (n 930) 46.13.

939 See Rayney (n 69) Chapter 20 for full details on pension scheme strategies that may be adopted by owner-managed companies. The account provided is illustrative only. See also: GOV.UK, *Tax on Your Private Pension Contributions* <https://www.gov.uk/tax-on-your-private-pension/annual-allowance> accessed 3 April 2022.

> realms of employer (or company) schemes… employer-based schemes offer the opportunity to save far more and accrue higher benefits far more swiftly…
>
> Whereas personal contributions are limited to 100% of earnings, there is no such limit on contributions by the employer, provided that the total does not exceed the annual allowance…where the employee has control over a profitable company a pension arrangement may prove to be a very beneficial use of funds.[940]

Payments into private pensions made by owner-managed companies are treated beneficially in five very important respects.[941] Firstly, subject to the warning provided in the following paragraph, the company can deduct the pension payments from the calculation of taxable profits, thereby taking them out of the corporation tax remit. A closely related, second, benefit is that contributions (at the time of writing the limit was £3,600) 'can be paid without reference to the level of the individual's earnings. This useful feature enables proprietors of…owner-managed companies to provide pensions for their [family]'[942] Thirdly, the premium paid is not a benefit in the employee's hands and specifically excluded from NICs liability on that basis.[943] Fourthly, the company need not pay NICs on contributions to registered pension schemes.[944] Finally, the contributions are not subject to the limits applied to contributions made by individuals. Accordingly, the employer (company) schemes provide the opportunity to save more and accrue higher benefits more quickly.[945]

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940 McLaughlin and Anderson (n 124) 81-82. For specialist information on this area see Alec Ure, *Tax Efficient Retirement Planning* (Bloomsbury Professional 2014).

941 Though there are many benefits Rayney (n 69) Chapter 10.

942 Rayney (n 69) 577. 'Contributions can be made using the normal expenditure out of income exemption from IHT.'

943 McLaughlin and Anderson (n 124) 55. ITEPA 2003, s 308; Social Security (Contributions) Regulations 2001 ("**SSCR 2001**"), SI 2001/1004, Sch 3, Part VI, Reg 2(a).

944 SSCR 2001, Sch 3. Rayney (n 69) 561: 'However, FA 2013 blocked a loophole that previously enabled employers to make contributions to pension schemes of their employees' other family members' pensions.'

945 McLaughlin and Anderson (n 124) 81.

There are potential traps in taking advantage of the generous tax treatment of payments into pensions. If a controlling director chooses to take a small salary and then procure the company to make large pension contributions, there is a risk that HMRC may seek to argue that the payments are not made 'wholly and exclusively' for the purpose of the business and thereby disallow the deduction at company level. It will also be difficult to satisfy the 'wholly and exclusively' requirement in circumstances where a company makes pension contributions for members of the family who are only passively engaged with the company or provide minimal services. The key is therefore to ensure that the total remuneration package (salary and pension contributions together) is comparable to that paid to an unconnected employee performing similar tasks. In the event that a commercially comparable situation cannot be detected, it will likely be more difficult for HMRC to challenge the arrangement. This may offer a certain degree of security for some owner-managers, though risk taking activity on this front is not to be encouraged.[946]

In Freedman and Godwin's study, the availability of pension advantages ranked seventh out of thirteen reasons for incorporation, with 25.6% saying that it was important.[947] The author's survey also invited views upon the extent to which pension planning opportunities were an advantage of operating as a company. As can be seen from the below, the majority of accountants agreed that this was an advantage of the company form (77.1%)[948] (Figure 194) though cross-tabulation of the results by reference to qualification simultaneously

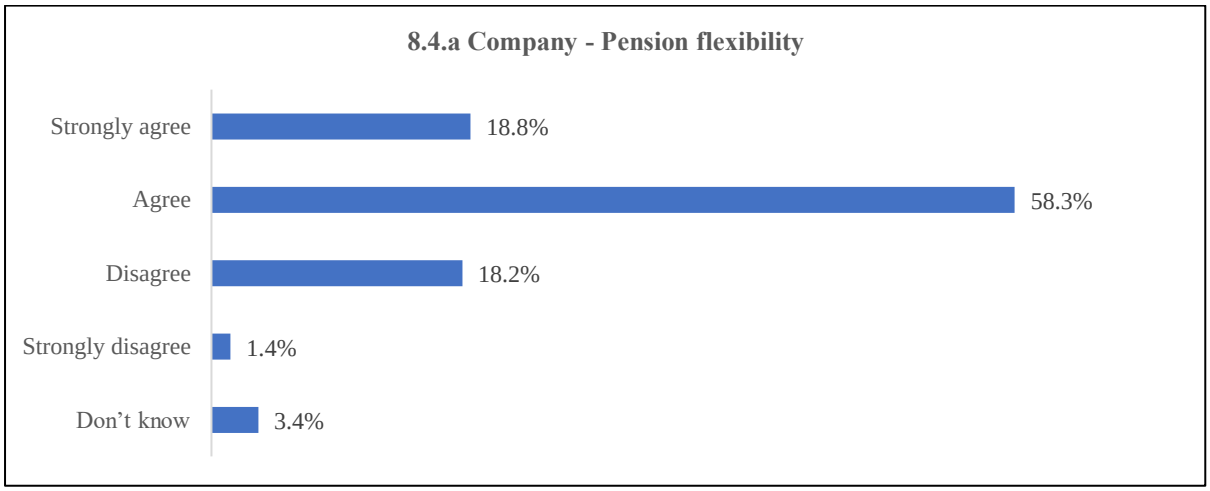
946 McLaughlin and Anderson (n 124) 54. See also guidance in HMRC, Business Income Manual, BIM46030, BIM46035, BIM47105-47106 <https://www.gov.uk/hmrc-internal-manuals/business-income-manual> accessed 4 April 2022.

947 Freedman and Godwin (n 33) 247.

948 275/357.

demonstrates a very high level of agreement in the Chartered Tax Advisor category (90.3%),[949] and much lower levels in the Tax Technician bracket (42.9%)[950] (Figure 195).

Figure 194: Agreement that pension flexibility is an advantage of the company[951]

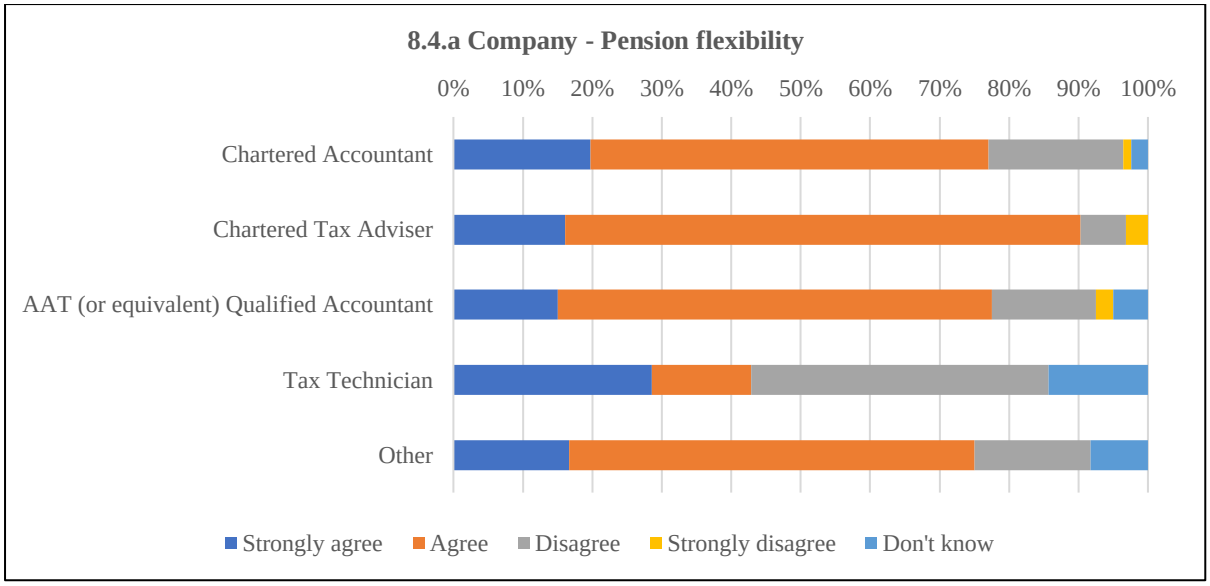


949 28/31.

950 3/7.

951 Cross-tabulated data for experience and firm size has not been presented since the overall difference in viewpoint amongst the categories was less than 5%.

Figure 195: Agreement that pension flexibility is an advantage of the company, by reference to qualification



Pension planning was again ranked towards the bottom of the list of advantages, coming seventh out of the nine options provided. The fact that it was not explored in the HMRC Reasons Behind Incorporation study as a possible reason for incorporation also appears to indicate that this is not a primary reason for incorporation, but perhaps the range of additional options and advantages are pleasant consequences for some owner-managers utilising the company form.[952] Indeed, it appears that notwithstanding the increased number of options for pension planning, many company directors are still choosing to stick with the ordinary PPP.[953] Adam, Miller and Pope's research also concluded that taxation does not appear to be influencing pension saving:[954]

952 It is possible that this was treated synonymously with taxation for the purposes of the study, but there is no indication of this in the report.

953 McLaughlin and Anderson (n 124) 81. Cory (n 930) 46.4: 'the pension rules allow £3,600 pa to be paid into a pension with the benefit of tax relief without any earnings. In practice, few people pay more than that as pension contributions.'

954 Miller, Pope and Smith (n 880) 19.

> [w]e cannot observe pension contributions or savings. However, pension saving is a cost that is deducted when calculating when calculating company profits, which means that if pension saving was a key mechanism used by owner-managers, we would expect to see total income respond to changes in marginal rates…there is no evidence of this.

This may be due to the associated risks described above, or simply because this type of planning adds a further layer of complexity to the arrangement that is regarded as unnecessary in the majority of cases, especially considering the other tax savings that can be made (by much easier methods discussed above) in the company form. In any event, it is positive that at least in this respect, sound economic reasons appear to be influencing the mode and means of pension saving by owner-managers, rather than the tax system.

4.6 CONCLUSION – TAX MATTERS

Ultimately, 'the combination of lower rates of tax on capital incomes relative to salaries, and the ability to smooth taxable income over time makes operating as a company owner-manager the most tax advantaged legal form in the UK.'[955] Any potential or existing business owner-manager would be perfectly rational in taking that factor into account in the selection of business form, and indeed the evidence presented above suggests that it is highly likely that they do so, as do their advisors.

It is also the case that the number of sole traders grew by 783,000 (+28%) between 2010-20,[956] notwithstanding the fact that they also endure the same self-employment 'tax penalty' as partners. This being so, one might fairly question the accuracy of the proposition

955 Miller, Pope and Smith (n 880) 14.

956 Business Population Estimates 2020 (n 3) 9.

that the decline in the number of partnerships can (at least in part), be attributed to tax-motivated incorporation; surely the number of sole traders would also be declining. However, that is not necessarily so. Firstly, it is important to appreciate the new ways of working that have emerged over the past decade, and in particular the rise of the gig-economy.[957]

> Growth of Britain's gig economy has been profound. In a mere five years, companies like Uber and Deliveroo, which enable transportation and delivery at the tap of a button, seem to be fundamentally changing our ways of working… while online platforms for sourcing gigs (in the form of 'crowdwork') have existed for more than a decade, the trend has accelerated in the UK since 2012.[958]

In 2017, Balaram, Warden and Wallace-Stephens estimated that there were 1.1million gig-economy workers in Great Britain, all of whom are classified as sole traders for tax purposes.[959]At the time, that amounted to nearly as many workers as employed by the National Health Service (NHS) England (1.2 million), and 35.5% of the overall business population of non-employing sole traders.[960] These labour-platforms are not designed with a partnership structure in mind, instead being a means to independent, flexible working for the *individual*. Accordingly, they will contribute to increased numbers of sole traders, but will not influence the number of partnerships (certainly not in any significant way). In this way, the rise of the

957 See Taylor Report (n 1).

958 Brhmie Balaram, Josie Warden and Fabian Wallace-Stephens, *Good Gigs: A Fairer Future for the UK's Gig Economy*, April 2017, 10 <https://www.thersa.org/globalassets/pdfs/reports/rsa_good-gigs-fairer-gig-economy-report.pdf> accessed 3 April 2022.

See also, for a global perspective, McKinsey & Company, *Independent Work: Choice, Necessity, and the Gig Economy*, October 2016 <https://www.mckinsey.com/~/media/mckinsey/featured%20insights/employment%20and%20growth/independent%20work%20choice%20necessity%20and%20the%20gig%20economy/independent-work-choice-necessity-and-the-gig-economy-full-report.pdf> accessed 3 April 2022.

959 Balaram, Warden and Wallace-Stephens (n 958) 13.

960 Business Population Estimates 2017 (n 7) 4.

gig-economy stabilises the overall numbers of sole-traders, and even contributes to growth, but does not act as a saviour for partnership structures.

Secondly, and highly significant, is a simple fiscal consideration. The tax benefits of incorporation have already been highlighted, and the mathematics is simple; the greater the number of people, the more potential savings there are (assuming that the business is profit making).[961] The prevalence of income *splitting* is well-known, and something that HMRC is yet to successfully challenge where company spousal configurations are in place. That is not without trying; HMRC unsuccessfully litigated the application of the 'settlements provisions'[962] to such arrangements in *Jones v Garnett* ("**Arctic Systems Case**").[963]

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961 As already indicated, loss-making businesses would be better placed to operate as partnerships, though such losses are not always anticipated by those starting up. Constable (n 429) 45.46, provides the following example: 'Mr and Mrs Sunny decide to start a new business installing 'green' energy systems for householders. Mr Sunny is a successful solicitor and Mrs Sunny will have the most involvement in the new partnership. They enter into a partnership agreement under which any profits will be shared 10% to Mr Sunny and 90% to Mrs Sunny, while any losses will be borne 90% by Mr Sunny and only 10% by Mrs Sunny. This arrangement could be tax efficient since Mr Sunny is a higher rate taxpayer while Mrs Sunny has no other taxable income; if there are profits they will initially be covered by Mrs Sunny's personal allowance and basic rate band, while if there are losses they will primarily be relieved against Mr Sunny's higher rate taxable income. An important caveat to this is that if Mr Sunny is a non-active partner (ie he is involved in the partnership business for fewer than ten hours a week) his share of any partnership losses will be restricted.'

962 ITTOIA 2005, ss 624-626. The effect of these provisions would be to deem the income of the donee as that of the donor for income tax purposes, thereby undercutting any potential benefits associated with income splitting.

For detailed discussion of income splitting arrangements and the application of ITTOIA, Pt 5, Ch 5 (inclusive of the above, but also more broadly) see Loutzenhiser (n 659) Ch 31.

963 *Jones v Garnett (Her Majesty's Inspector of Taxes)* [2007] UKHL 35.

Rayney (n 69) 290-91: 'For many years, HMRC often tried to apply the settlement legislation in ITTOIA 2005, s 625 to the wife's dividends with the view to taxing them on the 'settlor-husband', usually at his much higher tax rates. However, HMRC's ability to invoke the settlement rules has now been significantly restricted following…the *Arctic Systems* case. This involved a 'husband and wife' company. The husband (Mr Jones) was responsible for earning all the company's profits but drew only a minimal salary. Mr Jones was the sole director and chairman of the company, which enabled him to control both the day-to-day and the strategic management of the company. The share-owning structure gave the ability to pay substantial dividends, half of which went to his wife (Mrs Jones) by virtue of her 50% shareholding in the company. The House of Lords had little difficulty in finding that Mr Jones had created a settlement in which his wife had an interest. Mrs Jones obtained her shares at a considerable under-value and these shares 'enabled her to receive dividends on the shares which were expected to be paid' – this was sufficient to constitute an 'arrangement' and therefore fell within the 'settlement' definition. However, although there was a settlement, the Law Lords held that the *ordinary shares* fell within the exemption

> Despite early indications, no legislation has been introduced in response to the judgement in the Arctic Systems case. It remains the case, therefore, that outright gifts between spouses (for example gifts of shares in a company or of interests in a partnership) will not fall within the settlements legislation, and so income of the recipient will not be taxed on the spouse making the gift. The settlements legislation may, however, apply in respect of gifts between spouses that relate wholly or mainly to a right to income (or to a gift from a parent to a minor child); in such cases, the income may indeed be taxed on the individual who has made the gift.[964]

Though there is still some room for investigation in respect of director remuneration:

> The spouse's remuneration as a director of the company will be scrutinised by HMRC. If the remuneration is considered excessive, HMRC will probably seek to disallow all or part of it in the company's corporation tax computation, following the principle established in *Copeman v William Flood & Sons Ltd 24 TC 53*. Having said this, it may be possible to provide the wife with a substantial level of dividend income with little or no further tax liability…[965]

HMRC have suggested that some partnership arrangements could be challenged under the settlements provisions,[966] 'where the incoming partner receives a share of profits out of all

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for outright gifts between spouses (in what is now ITTOIA 2005, s 626). This was because the ordinary shares were more than a pure right to income – they had a bundle of rights, including the right to attend and vote at general meetings, rights to capital growth on a sale, and to obtain a return of capital on a winding-up. Thus, the dividends were (beneficially) treated as the wife's income. The ruling in *Arctic Systems* still remains a persuasive precedent and owner-managed companies can therefore continue to make arrangements to pay 'tax beneficial' dividends to spouses with some confidence.'

The USA has also struggled to counter what might be seen as tax abusive allocations in owner-managed businesses. See: Bradley Borden, 'Tax Aspects of Partnerships, LLCs and Alternative Forms of Business Organisations' in Robert Hilman and Mark Loewenstein, *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations* (Edward Elgar Publishing 2015).

964 Constable (n 429) 45.45.

965 Rayney (n 69) 289-90.

966 ITTOIA 2005, s 626-626.

Jagadeesh Sivadasan and Joel Slemrod, 'Tax Law Changes, Income-Shifting and Measured Wage Inequality: Evidence from India', 2008 Journal of Public Economics 2199, highlight this issue in India, noting that this ultimately led to the introduction of entity level taxation of partnerships.

proportion to the contribution to the partnership.'[967] The examples where HMRC would class a partnership as a settlement for income tax purposes include:[968]

> Example 10 – sleeping partner – settlements legislation does apply
>
> Mr Y, an architect, commences business as a sole trader. The business is successful and a few years later annual profits are in the region of £80,000. The business is transferred to a new partnership of Mr & Mrs Y. A deed is executed under which income profits are to be shared equally but the rights to share in capital profits belong solely to Mr Y. Mrs Y subscribes no new capital and carries out no work whatsoever for the partnership, that is to say she is a sleeping partner. Profits for the year are £80,000 and £40,000 belongs to Mrs Y. This is a bounteous arrangement transferring income from one spouse to another. The settlements legislation will apply and Mrs Y's share of the profits will continue to be assessed on Mr Y…
>
> Example 11 – Gift with conditions attached
>
> Mr T is in partnership with his wife Mrs T. Their daughter is a university student. The deed is altered to admit the daughter as a partner. All the partners agree that on finishing her course the daughter's interest in the partnership will come to an end. The amendment of the partnership agreement under which the daughter is included without any additional capital or value being added by her is an arrangement with the requisite element of bounty. The gift from the parents is subject to conditions under which the property given will revert to them. The daughter's income is therefore treated as the income of the parents…

Notwithstanding the above, HMRC's published position is also that:

> where the incoming partner is a spouse or civil partner and he or she acquires an unlimited share in the partnership *assets and income* (emphasis added) and there are no other arrangements or conditions applied to the gift then the exemption for outright gifts will apply and a challenge under the settlements legislation is not appropriate.

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967 HM Revenue & Customs, Trusts and Estates Manual TSEM4215, 2 May 2016 <https://www.gov.uk/hmrc-internal-manuals/trusts-settlements-and-estates-manual/tsem4215> accessed 30 March 2022.

968 ibid. See also HM Revenue & Customs, Guidance HS270 Trusts and Settlements – Income Treated as Settlor's, 6 April 2022<https://www.gov.uk/government/publications/trusts-and-settlements-income-treated-as-the-settlors-hs270-self-assessment-helpsheet/hs270-trusts-and-settlements-income-treated-as-the-settlors-2015> accessed 15 April 2022.

Effectively, so long as the partnership *property* also comprises part of the gift, the associated partnership income right will not be contested by HMRC.

The opportunity for additional savings via income splitting stems 'from the combination of the independent taxation of couples and a progressive rate structure in the personal tax system.'[969] It is almost certainly the case that additional family members have been introduced as partners, shareholders, and directors into a business structure purely to facilitate tax savings. [970]

> Many owner-managed companies provide shares to the spouse to secure the tax benefits of paying dividends to a basic rate taxpayer. This strategy still remains attractive following the changes to the dividend tax regime. Under the current regime, where the spouse's dividend income is covered by her personal allowance (£12,500 for 2020/21) and/or dividend 'nil rate' band (£2,000 for 2020/21), they would have no tax liability. Where the spouse's dividend income exceeded these amounts, they would only incur a tax liability of 7.5% on the taxable amount (assuming the cash dividend amount fell within their basic rate band, which is £37,500 for 2020/21).[971]

To the extent that this form of artificial planning is considered by the owner-manager, the company is usually the more tax beneficial option, such that individuals who would have previously utilised the partnership for income-splitting may now have switched to the company, thereby contributing to a decline in numbers of the former. Of course, this tax-

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969 Adam and Miller (n 4) 71 and continuing: '[w]ith such a tax system, it is difficult to prevent income-splitting since it is hard to determine how much of the income from a business should be correctly attributed to each individual.'

970 Constable (n 429) 45.43: 'There will be many cases where family members – particularly spouses – are members of the same partnership (either alone or with others) for reasons completely unrelated to tax. In other cases, it may be that a small business could simply be carried on by one member of a married couple, but that the couple wishes to consider carrying on the business in partnership for the tax savings that could result.'

971 Rayney (n 69) 290-91.

motivated incorporation is troubling by reference to the principles of good taxation, but if the income-splitting behaviour is purely a manifestation of tax planning activity, then it is undesirable whether it takes the form of a partnership or a company.

Beyond the artificial, are the instances where would-be partners reasonably appreciate the extra savings that can be made by operating business through a company. These individuals already face additional practical, administrative and compliance hurdles as compared to the sole trader; there must be consideration of the partnership agreement, formal or informal (and associated costs) in addition to the requirement to file a separate partnership return with HMRC and the need to occasionally grapple with the complexities generated by applying a tax system designed for individuals, to individuals engaged in joint enterprise. Professional advice is typically sought and paid for in any event, so the formation of a company in cost and relative effort terms (particularly if faced with the upper-end charges for professional drafting of a partnership agreement) may appear to be a small additional step for the owner-managers in pursuit of tax savings, which are potentially substantial. It is the author's view that this small step is likely to have contributed to the steady decline in the number of ordinary partnerships. It also means that the tax tail wags the commercial dog for those otherwise would-be partners, which does not sit comfortably with the principles outlined in Part 3 of this Chapter.

Appreciation of the beneficial tax treatment of companies, can also assist in explaining why the LLP has not found favour with owner-managed businesses. Instead of being the best of both worlds (partnership-structure flexibility with corporate limited liability), it is, in truth, the worst of both worlds (potentially unfavourable partnership taxation with corporate compliance burdens). The retention of a partnership-style structure with limited liability is simply not attractive enough to justify the increased start-up, administrative, and taxation costs.

If the partnership element is deemed crucial to the operation of businesses, then it might be better to forgo limited liability - to the extent that it would be gained at all - for an overall cheaper and less complex approach. If limited liability, and/or tax savings are key, then the corporate form should offer financial benefits from its favourable tax treatment. Any idiosyncratic ideals of the owner-manager may be incorporated into the company articles of association. From this perspective, the LLP was doomed from the start in so far as most owner-managed businesses are concerned; the UK tax system can be seen as the nail in the LLP coffin.

CHAPTER 5: FUTURE STEPS & THESIS CONCLUSION

5.1 INTRODUCTION

By this stage, the prevalence of tax-motivated incorporation by owner-managers (being the most responsive individuals in the tax system)[972] is clear. The differential tax treatment of different business forms accounts for this behaviour, and the irrelevance of the gig-economy combined with increased potential savings for would-be partners means that the partnership is most likely to be hardest hit by the distortionary effects of the tax system. This is something that should not, and cannot, be maintained.

In January 2021, Adam and Miller published a comprehensive paper outlining available packages of reform to increase overall neutrality and equity within the tax system.[973] 'The most obvious way in which our taxes are non-neutral is with respect to legal form.'[974] They attribute previous policy mistakes to the utilisation of capital tax rates in particular to achieve two seemingly incompatible goals: taxing all income the same and not discouraging saving and investment.[975]

> The desire to create a fair system and stop tax-motivated changes in legal form suggests that capital income tax rates should be similar to labour income tax rates. But the desire to ensure that tax does not discourage saving and investment is often used to support lower tax rates. UK capital gains tax rates (CGT) rates – which have been moved up and down over time – provide a clear example of how politicians have chosen different points on this perceived trade-off…

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972 Adam and Miller (n 664) 16.

973 Adam and Miller (n 4).

974 Adam and Miller (n 4) 31.

975 Adam and Miller (n 4) 31.

> In recent years, there have been concerted attempts to address the problems created by having differential tax treatment of legal forms…But this approach is failing, and will continue to fail, because it cannot overcome the core problem: there is no coherent principle underlying the tax distinction between legal forms.

Unsurprisingly, their reforms are directed towards the tax system as a whole, and do not advocate the creation of new rules targeted at small (owner-managed) businesses, since this would be to introduce new boundaries, the existence of which is a problematic design element in the current approach to the taxation of both employees and the self-employed (inclusive of company owner-managers).

> [T]he changes we are suggesting may seem like a sledgehammer to crack a nut if one is focusing on one specific problem such as tax-motivated incorporation, but the real beauty of the approach is that it is not simply fixing one or two specific problems, but a whole raft of them, within the small business sector and beyond it…
>
> Perhaps, most notably, the reforms could be applied to (and fix problems associated with the taxation of) the full range of businesses, from sole traders to giant multinationals, with no need for separate regimes or arbitrary boundaries.[976]

The packages of reform, whilst they differ in detail, broadly seek to achieve the first goal of taxing all income the same by aligning rates of tax across all legal forms, the necessity of which has also been observed by the OTS as part of its Small Business Taxation Review.[977] The second goal of incentivising saving and investment is facilitated by adjusting the tax base

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976 Adam and Miller (n 4) 69.

977 Interim Report (n 273) 13: 'Maintaining two separate systems [of income tax and national insurance] leads to a number of anomalies that provide incentives to distort behaviour. This leads to decisions being taken that are wholly tax driven, and in many cases are more complex and may not otherwise make commercial sense. Reducing the differential between the income tax and NIC rates and treatments for different income streams and legal forms would reduce this incentive and simplify the system for taxpayers, their advisers and HMRC. We do, however, recognise that reducing the differential will not be an easy task, to ensure that there is no significant overall loss to the Exchequer or taxpayers.'

i.e. the funds subject to taxation in the first place.[978] There are trade-offs to be made, and the reforms are radical, but this is rendered necessary in pursuit of business form neutrality and horizontal equity. Minor amendments to the tax system have not been working.

The packages produced by Adam and Miller are inherently sensible, and the author does not seek to challenge their proposals, nor advocate for one package over another. Instead, this final Chapter simply seeks to address and invite the consideration of one crucial reform pertaining to the taxation of disincorporation. This could be a bolt-on reform sitting alongside those proposed by Adam and Miller; the OTS has noted that facilitating disincorporation appears to fit well with other proposals intended to reduce the number of tax motivated incorporations.[979]

Parts 5.2 and 5.3 discuss the taxation of disincorporation. Part 5.4 concludes this thesis. Those interested in a more radical reform option are invited to consult Annex E.

5.2 DISINCORPORATION (RELIEF)

Chapter 2 highlighted two key practical considerations for owner-managers considering disincorporation of the business: administrative costs and the need to settle/amend agreements with third parties. However, there are also tax charges that arise as part of the disincorporation process that potentially have lock-in effects. A HM Treasury consultation report in relation to disincorporation relief noted that all of its respondents regarded the tax barriers to

978 Adam and Miller (n 4).

979 Office of Tax Simplification, *Disincorporation Relief – What of the Future?*, July 2017 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/632889/Disincorporation_relief_focus_paper_July_2017.pdf> accessed 3 April 2022.

disincorporation as the most significant (more so than those discussed in Chapter 2).[980] The author's research indicates a more equivocal view in relation to the non-tax and tax barriers respectively, yet they are still evidently important.

> The main tax consequence under the current tax law of a disincorporation is a potential double tax charge on gains from the assets transferred: first on the company (which disposes of its assets) and second on the shareholders (who dispose of their shares). This double charge is inherent in the nature of the corporate status but is a barrier to many of the smallest businesses that wish to continue their business in a more suitable legal form.[981]

The OTS has also identified other tax issues that may arise as part of the disincorporation process. These include:[982]

- stock and work in progress would be deemed as having been disposed of at market value, though an election may be made under sections 167(1)-(4) CTA 2009 which has the effect of using the actual transfer (or book) value such that there is no charge;
- a market value charge may also arise on the disposal of plant and machinery, though an election can be made under sections 265-267 CAA 2001 to use the written down value such that there is no charge;

980 HM Treasury, *Consultation on a Disincorporation Relief: the Government's Response*, December 2012 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/190258/consult_govt_response_disincorporation_relief_111212.pdf> accessed 3 April 2022.

981 OTS Disincorporation Relief (n 200) 9.

982 OTS Disincorporation Relief (n 200) 11.

- whilst trading losses may be carried back and set against profits made in the final three years of business,[983] they cannot be transferred to the unincorporated business;
- capital losses, excess management expenses and non-trading loan deficits also cannot be transferred to the unincorporated business;
- there is a potential SDLT charge if there is a transfer of land, though a transfer in specie as part of the course of winding up (so long as there are no loans charged on the property) will not give rise to a charge.

Whilst of course these matters may be important to some, they will not be relevant to all owner-managers in the same way as the potential corporation and CGT (perhaps income tax) charges arising - many of the additional issues can also be mitigated to some extent, as indicated. Relieving the primary tax charges upon disincorporation is essential to achieving symmetry in a system that presently ensures no tax charges are due when an unincorporated business decides to incorporate.[984] Even the official government response to OTS research in relation to disincorporation relief conceded that 'some small businesses who have opted to become a limited company in the past may now feel "trapped" in a more onerous tax regime for companies and could benefit from moving to a simpler legal form.'[985] Within this category of 'small businesses' there are three distinct sub-groups that have been deemed by the OTS as likely to benefit from the existence of a disincorporation relief. Firstly, there are small businesses 'operating through a company, with little understanding of the notion of a legal entity separate from the shareholders/directors, and the consequent failure to keep personal

983 CTA 2010, s 39.

984 TCGA 1992, s 162.

985 HM Treasury, Consultation on a Disincorporation Relief (n 980).

cash separate from business.' As previously discussed, this can result in overdrawn loan accounts with associated tax charges. Many of these businesses may have incorporated to take advantage of lower effective tax rates applied to companies.[986] Secondly, there are 'older companies which have outgrown their original structure'[987] whereby one or more of the activities would be better suited to carry on as an unincorporated business. Thirdly, there are companies that have outgrown their original structure, because of a need to adjust the profit-sharing arrangements more flexibly by reference to relative time and effort of the individuals involved in the business; these companies might be better suited to the LLP form. The respondents to the OTS Disincorporation Relief research[988] believed a relief would be most beneficial for the former group:

> 29% of agents considered that very small businesses that incorporated in the past for tax reasons were likely to find the introduction of a disincorporation relief "very beneficial". However, companies [that have outgrown their original structure]…scored less highly, with only 8% of agents considering that a disincorporation [relief] would be "very beneficial" to companies wanting to disincorporate part of the business, and 11% for those that wish to move to an LLP structure.[989]

Reflecting on those findings further, it would make sense that individuals that have previously been responsive to (at least perceived) beneficial tax treatment in the corporate form, would also be mindful of any tax consequences of changing the operating form. If they

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986 The OTS linked tax motivated incorporation to the 0% starting tax rate introduced by Finance Act 2002, s 32: OTS Disincorporation Relief (n 200) 13. However, given the high entry-exit rates for small businesses the lingering effects of the 0% corporation tax rate are likely to be minimal today, and certainly less potent than when the OTS were writing at the beginning of 2012.

987 OTS Disincorporation Relief (n 200) 13.

988 OTS Disincorporation Relief (n 200) 7. Based upon a survey of tax agents in November 2011. Over 700 responses were received. This was supplemented by evidence obtained from a survey of small business owners by The Futures Company.

989 OTS Disincorporation Relief (n 200) 13.

were drawn-in by tax treatment, they will also likely be locked-in by tax treatment. The other two sub-groups appear to have more commercial considerations at the fore as a reason for disincorporation, and it is reasonable to assume that the initial incorporation is likely to have been non-tax motivated. That being the case, a tax-barrier might not suffice to override the commercially sensible decision. However, they will still be affected by the tax regime, and perhaps adversely so in this instance; this should not be ignored. Indeed, only a minority of the OTS respondents thought that the existence of a relief would not be beneficial for the non-tax motivated sub-groups; most selected the 'could be beneficial option' indicating that an appropriately targeted reform may still be put to good use.[990]

In terms of the number of interested parties 'the [OTS] evidence obtained suggests that a small but significant number of small businesses would like to disincorporate, with 14% of companies surveyed stating they would prefer to operate as an unincorporated business.'[991] Furthermore, '20% of agents surveyed said that at least 1 in 10 of their incorporated clients "would like to disincorporate but cannot or do not because of potential tax charges that would arise at the point of disincorporation".'[992] 'Businesses with turnover between £20,000 and £30,000 per annum [i.e those with access to only modest savings by operating as a company] were more positive than average to the idea of disincorporation, as were businesses that have low confidence over their tax affairs.'[993]

> The OTS understands this population is most likely to consist mainly of small one-person or family companies, which:

990 OTS Disincorporation Relief (n 200) 14.

991 OTS Disincorporation Relief (n 200) 5.

992 OTS Disincorporation Relief (n 200) 5.

993 OTS Disincorporation Relief (n 200) 14.

- were not formed in order to obtain, or do not need, limited liability, and
- do not, or no longer, need to be incorporated to satisfy criteria applied by suppliers on certain contracts [i.e. two of the key commercial motivations for adopting the corporate form are inapplicable].[994]

The principles of horizontal equity, neutrality and efficiency all clearly demand that incorporation should not be a tax-motivated action, but the reverse also has to be true; owner-managers should not potentially be tax-disadvantaged by being tied to the corporate form (though admittedly this is more of a possibility than a reality for many). A business which would be better suited to the unincorporated form should not effectively be forced to continue operating as a company because the tax charges associated with disincorporation act as a disincentive to do so – this raises equity and neutrality concerns. Being locked into an inefficient business form generates deadweight economic losses, which are also undesirable. Furthermore, the additional administrative burdens associated with operating as a company are well-known and have a disproportionate effect on the smallest businesses.[995] The availability of tax-relieved disincorporation would ensure that these administrative burdens are not unnecessarily endured: '[disincorporation] would free the business from the additional administrative burdens that apply to limited companies and so generate more time to spend on running the business.' [996]

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994 OTS Disincorporation Relief – What of the Future? (n 979) 4.

995 HMRC Reasons Behind Incorporation (n 25) 57-58: **'**Attitudes to the administrative burden were linked to financial position: those with a low turnover (less than £25,000) were more likely to agree that the administration was too much of a burden (44 per cent), as were those who broke even (49 per cent) or made a loss (42 per cent) rather than made a profit (28 per cent). Similarly, those who had not made tax savings through incorporation were more likely to agree that the administration was too much of a burden than those who had made savings (40 per cent of those who had not made tax savings compared with 30 per cent of those who had made savings) … there was no difference between those that used an external agent and those who carried out administration internally.'

996 OTS Disincorporation Relief (n 200) 17.

The following two sections detail how the tax charges upon disincorporation work in practice, and present confirmatory evidence from the author's empirical research that the tax system is likely to be having a deterrent effect upon potential acts of disincorporation. This provides the basis for the discussion in Part 5.2.3 of the essential form that disincorporation relief ought to take.

5.2.1 Tax Payable by the Company

Within the company there will be an element of goodwill (although in some cases it will be minimal), which will be taxed upon a transfer to the unincorporated business. The disposal will be deemed to have taken place for market value consideration.[997] 'Agreeing the value of goodwill with HMRC can be a lengthy process and this can be burdensome for all sides,'[998] and can be the most problematic element of the transfer. The treatment of goodwill for tax purposes will be determined by the date upon which the company business commenced or was acquired. For those starting up or acquiring the company after 31 March 2002, the goodwill is taxable as trading income of the company under the intangible fixed assets regime.[999] Otherwise, a chargeable (in effect capital) gain may arise. In addition, gains will also arise upon the transfer of other assets, such as property and plant and machinery, to the unincorporated business – technically the owners thereof. The market value must once again be ascertained, though this process will likely be simpler than the valuation of goodwill.[1000] There is no rollover or holdover relief for disincorporation so all gains will be immediately

997 CTA 2009, ss 835, 845.

998 OTS Disincorporation Relief (n 200) 9.

999 CTA 2009, Pt 8. This also applies to the transfer of any other intangible assets.

1000 CTA 2009, ss 166, 168.

chargeable. If the company does not have the capacity to pay the tax due, then the owner-manager may need to purchase the assets from the company to provide it with the necessary liquidity. Of course, the individual will need to possess sufficient funds to transact in this way.

Overall, 55.9%[1001] of the respondents to the author's survey agreed that tax payable by the company was a barrier to disincorporation (Figure 196), including 100%[1002] of Tax Technicians (Figure 197). At the other end of the spectrum, 48%[1003] of those possessing qualifications in the 'Other' category agreed, with the remaining qualification categories recording similar levels of agreement (Chartered Accountant – 55.7%;[1004] Chartered Tax Advisor – 55.2%;[1005] AAT (or equivalent) Qualified – 54.5%).[1006] Respondents with 1-5 years' experience of advising owner-managed businesses were less likely to view the tax payable by the company as a barrier to disincorporation (42.9%)[1007] than their more experienced counterparts (6-10 years' experience – 60.7%;[1008] more than 10 years' experience – 56.2%)[1009] though there is no overall correlation between length of time advising and viewpoint on this matter (Figure 198). The gathered data also evidences variations in opinion across respondents in different firm sizes, though again there is no identifiable trend (Figure 199).

1001 188/336.

1002 7/7.

1003 12/25.

1004 131/235.

1005 16/29.

1006 21/38.

1007 9/21.

1008 17/29.

1009 159/283.

Figure 196: Agreement that tax payable by the company is a barrier to disincorporation

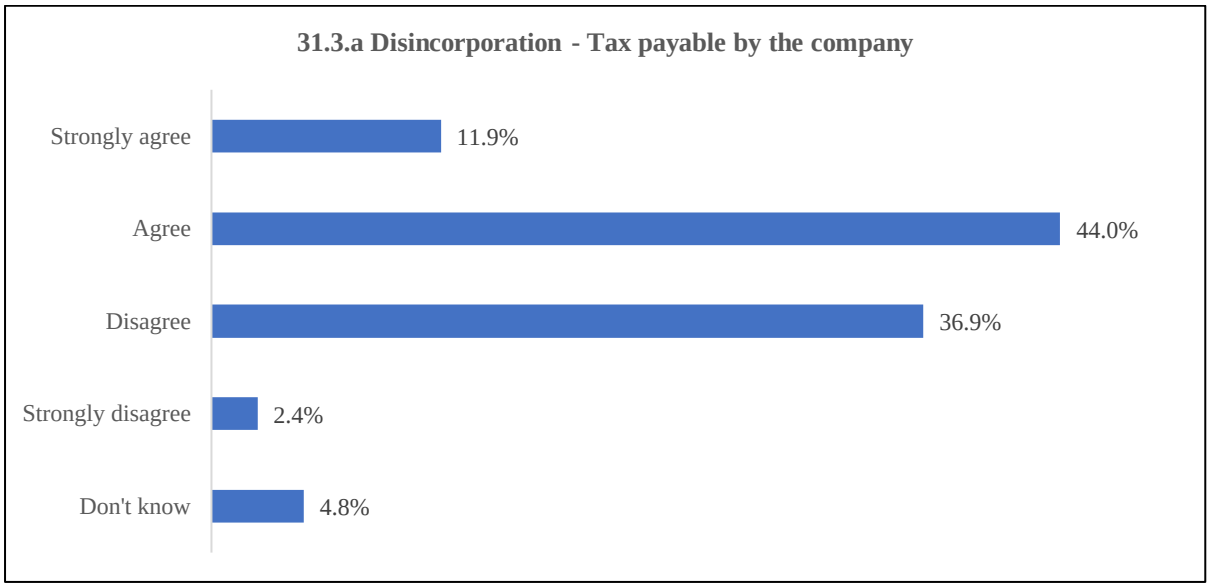


Figure 197: Agreement that tax payable by the company is a barrier to disincorporation, by reference to qualification

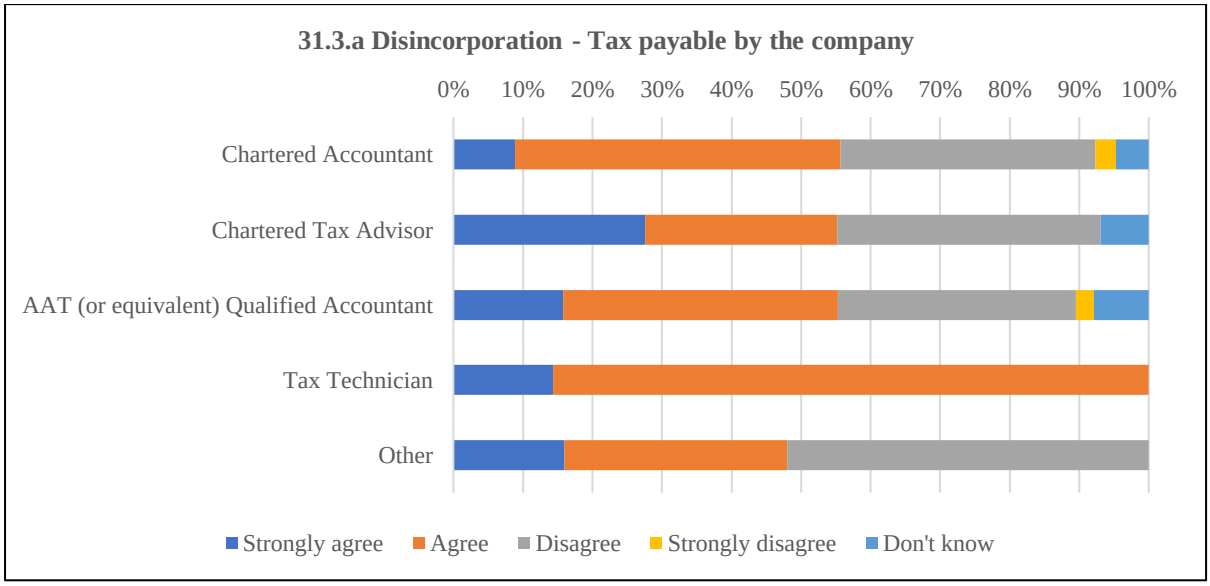


Figure 198: Agreement that tax payable by the company is a barrier to disincorporation, by reference to experience

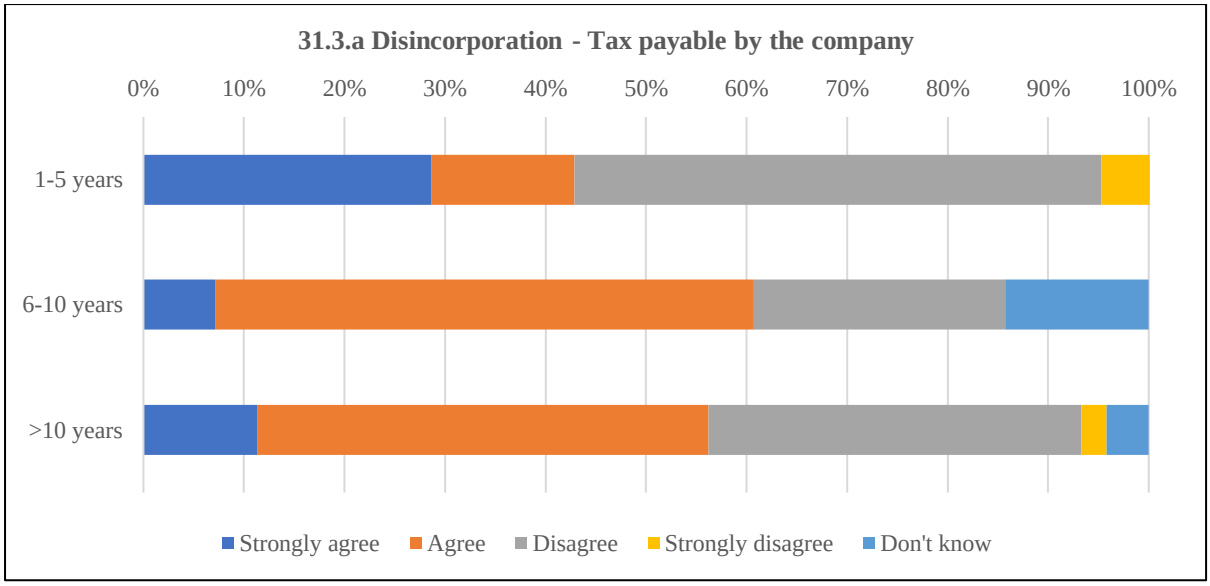
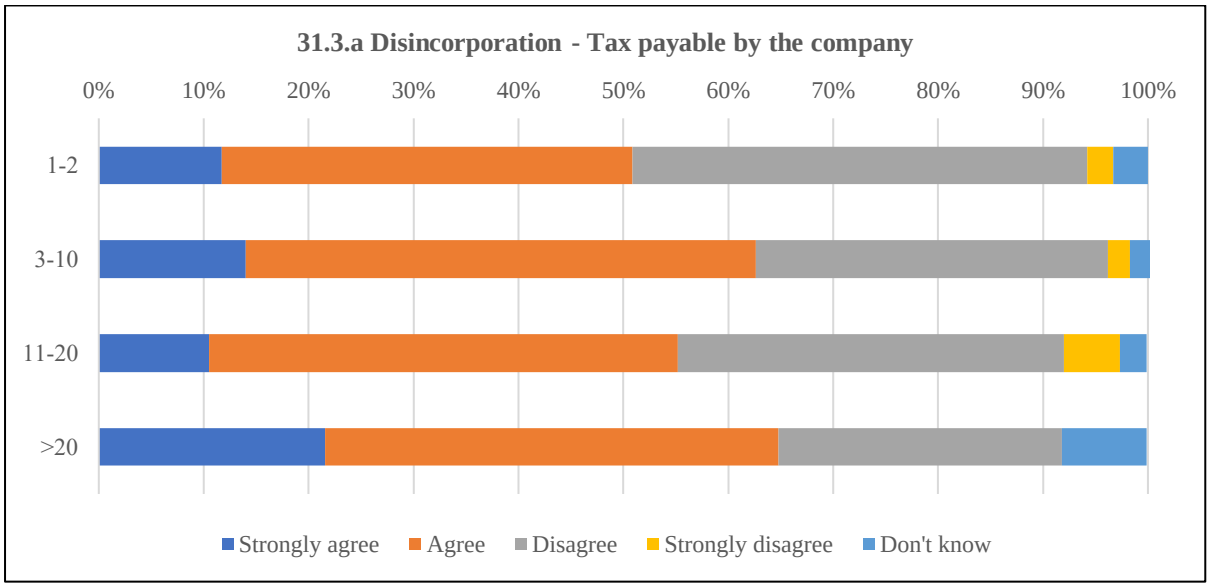


Figure 199: Agreement that tax payable by the company is a barrier to disincorporation, by reference to firm size



5.2.2 Tax Payable by the Shareholders[1010]

If the company is wound up and accompanied by a distribution of assets to the shareholders, the shareholders will be liable to pay CGT to the extent that their personal allowance is exceeded in the given tax year.[1011] This treatment can be challenged by HMRC under the transactions in securities anti-avoidance provisions[1012] where they believe that the arrangements were entered into to obtain a tax advantage.[1013] In this case a counteraction notice would be issued thereby resulting in the distribution being treated as an income (rather than capital) distribution for tax purposes.[1014] The predecessor legislation was deemed to apply to disincorporation activities in *CIR v Joiner*[1015] in circumstances where the former shareholders continued in business having extracted the company's distributable reserves in the capital form.[1016]

> Even though trade is being transferred into personal ownership (rather than a commonly owned company) on disincorporation, it may be prudent to assume that HMRC would seek to counteract the tax advantage from the winding up where it appears that the disincorporation is only being effected to extract the company's reserves (in an income tax-free form) as a capital receipt taxable at beneficial CGT rates…

1010 Owner-managers in their personal capacity. McLaughlin and Anderson (n 124) 421: 'No tax charge will arise on the shareholder(s) if the business is [effectively] disincorporated through a sale by the company to the shareholders for cash consideration equal to its market value, but a tax liability may arise on any subsequently [*sic*] cash distribution by the company to the shareholder(s)'. The owner-managers would also need to have sufficient personal cash reserves to implement this planning strategy; it is unlikely to be viable for most, if for no other reason than the complexity involved.

1011 OTS Disincorporation Relief (n 200) 9. CTA 2010, s 1030. BADR may be available to lower the effective tax rate.

1012 ITA 2007, Pt 13, Ch 1.

1013 ITA 2007, s 684.

1014 ITA 2007, s 698.

1015 [1975] STC 657.

1016 See also HMRC, Company Taxation Manual, CTM36850, 16 April 2016 <https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm36850> accessed 4 April 2022.

> However, a HMRC challenge may be less likely where most or all of the disincorporating company's funds will be required by the successor business [as will often be the case for owner-managed businesses], or where the extent of the tax liabilities arising for both the company and shareholders on disincorporation supports the argument that it would not have been undertaken purely to obtain a tax advantage [as could also be the case for owner-managed businesses].[1017]

The transactions may also be treated as an income distribution by anti-phoenixing rules, that are similarly targeted at tax-motivated windings up.[1018] The target-audience of 'locked-in' owner-managers are unlikely to be affected by such rules, but their existence and threat of application adds a level of complexity and uncertainty to the disincorporation process.

If the distribution takes place otherwise than as part of a winding up, there is an income distribution for tax purposes where the total distributions are £25,000 or more.[1019] The tax is levied by reference to 'the excess distribution received over the tax cost of their respective shareholdings.'[1020] This, combined with the tax payable by the company as part of the disincorporation process results in what is effectively a double tax penalty in changing business form post-incorporation.

1017 McLaughlin and Anderson (n 124) 419. If in doubt, an ITA 2007, s 701 clearance should be obtained from HMRC.

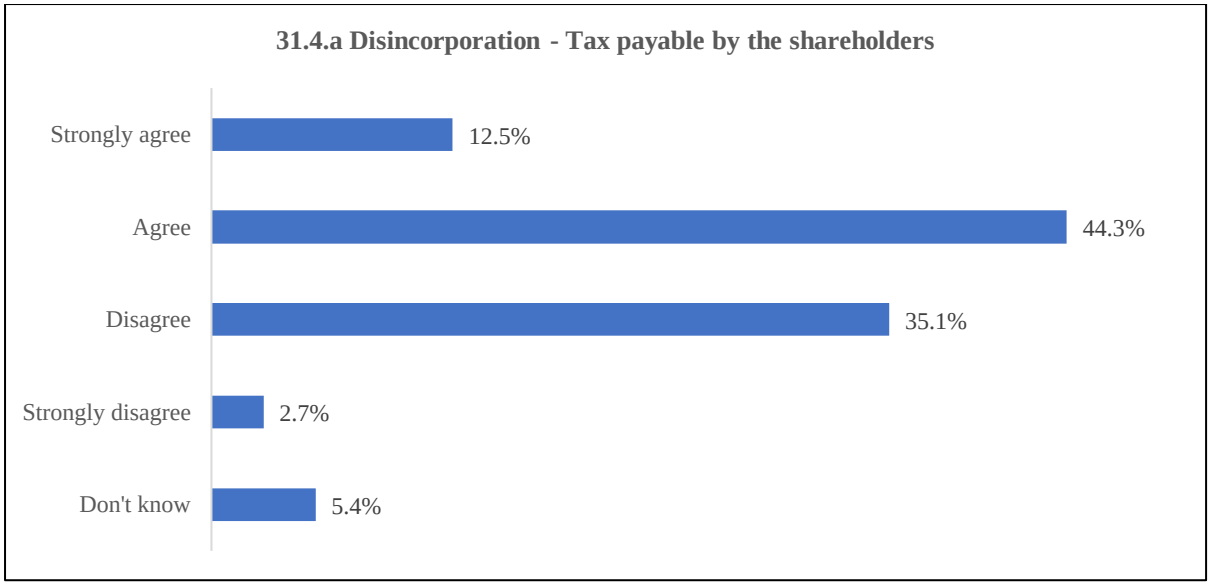
1018 ITTOIA 2005, s 396B. There is no clearance process for these rules.

1019 CTA 2010, s 1030A. A legislated statutory concession (formerly ESC C16, now Enactment of Statutory Concessions Order 2012, SI 2012/266, Art 16) provides for CGT treatment in the event that there is a transfer of assets to the shareholders in circumstances where there is no intention to continue trading.

1020 OTS Disincorporation Relief (n 200) 10.

56.8%[1021] of the respondents to the author's survey agreed that tax payable by the shareholders is a barrier to disincorporation (Figure 200).[1022] Once again, Tax Technicians and 'Other' category respondents recorded the highest and lowest levels of agreement respectively (100%[1023] and 40%) (Figure 201).[1024] On this point, the cross-tabulation against length of time advising and firm size do evidence correlative results; levels of agreement grew with length of time advising (Figure 202), and increases in firm size (Figure 203).

Figure 200: Agreement that tax payable by the shareholders is a barrier to disincorporation



1021 191/336.

1022 Note that this is extremely similar (+0.9%) to the number of respondents believing that tax payable by the company is a barrier to disincorporation.

1023 7/7.

1024 10/25.

Figure 201: Agreement that tax payable by the shareholders is a barrier to disincorporation, by reference to qualification

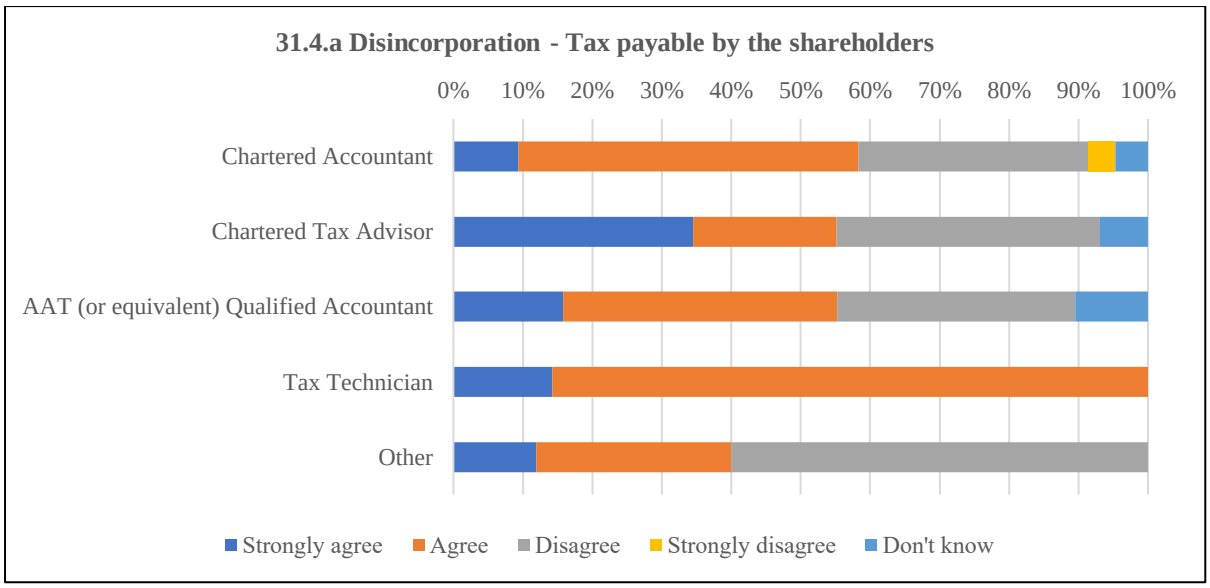


Figure 202: Agreement that tax payable by the shareholders is a barrier to disincorporation, by reference to experience

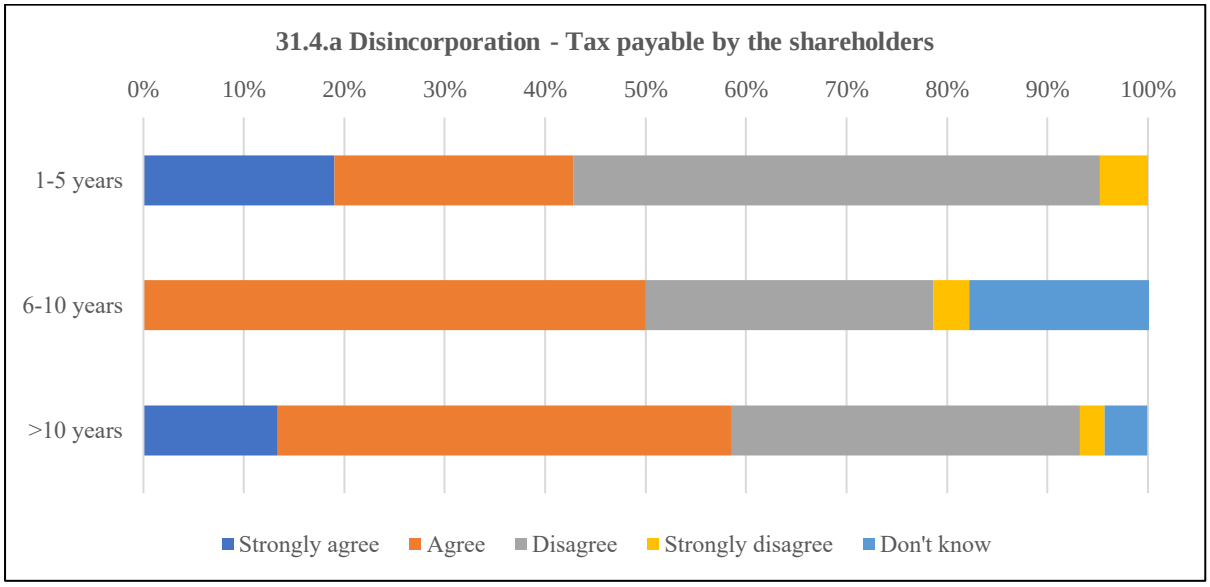
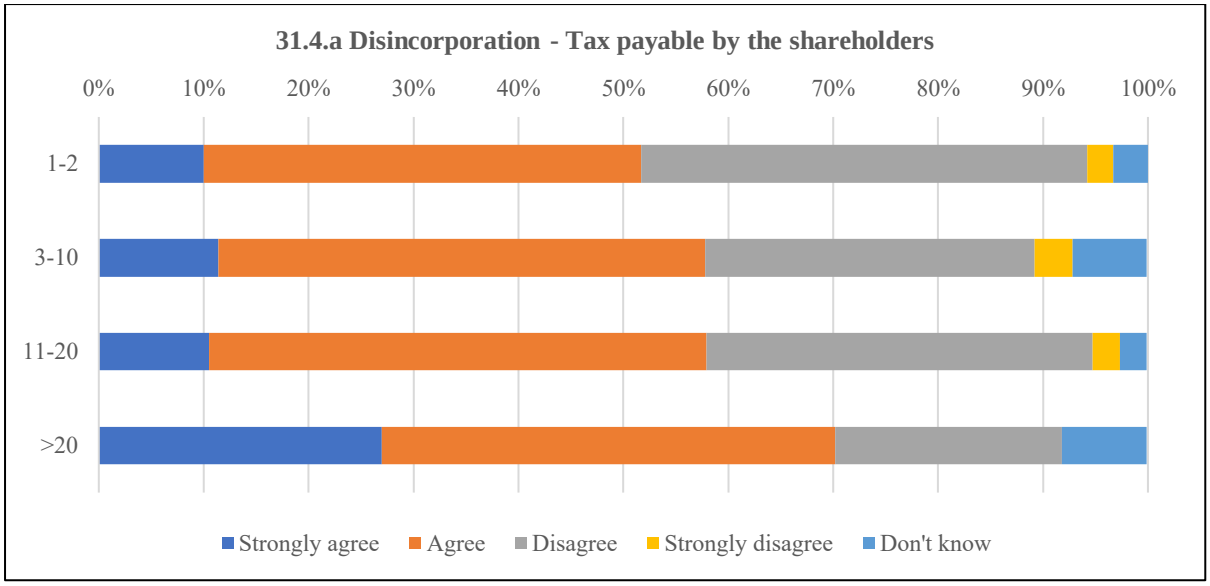


Figure 203: Agreement that tax payable by the shareholders is a barrier to disincorporation, by reference to firm size



The survey responses generally indicate that whilst the tax charges associated with disincorporation will not act as a barrier to disincorporation for a substantial proportion (approximately half based upon the results) of owner-managed businesses, it is nonetheless likely to be an issue for some. As previously discussed, the OTS Disincorporation Relief report emphasised that low-turnover businesses and those that had low confidence in relation to their tax affairs were most likely to favour disincorporation,[1025] yet it is this group of owner-managed businesses that are also most likely to be locked in by the associated tax bill if one is to arise. They are least likely to be able to pay, especially where the business has accrued goodwill, and least likely to comprehend the complexities of the taxation of disincorporation (particularly the calculation of goodwill for the purposes of company taxation, and the threat in application of anti-avoidance rules to capital distributions of the company reserves). The barrier may not be one for all, but a pertinent one potentially encountered by those owner-

[1025] OTS Disincorporation Relief (n 200) 14.

managed businesses for which disincorporation would be most beneficial. In any event, the existence of any tax barrier for disincorporation, particularly where the same does not exist for incorporation, places the tax system in conflict with the fundamental principles of neutrality, horizontal equity and efficiency. The complexity of the rules also gives rise to additional administrative and compliance burdens for owner-managed businesses seeking to disincorporate.

5.2.3 Form of the Relief: Past, Present and Future

In February 2012, the OTS proposed the introduction of a disincorporation relief. **'**The rationale behind the relief is to allow those small businesses that no longer wish to operate through a corporate entity to move on a tax-neutral basis to unincorporated status.'[1026]

> [T]he proposed relief would enable a company holding internally generated goodwill, plus land and buildings and machinery and plant wholly used for the trade, to pass to an unincorporated structure, with no tax charge arising on the company, and no distribution charge on the shareholders, as a result of the transfer of those assets. Any gain arising on the value of goodwill, and on the land and buildings used for the trade would be charged when the business (or the individual asset) is disposed of. For example, a business that started life as a sole trader, then incorporated, and subsequently disincorporated back to sole trader, would continue to hold the goodwill and land and buildings used for the trade for tax purposes as if the transfer into a limited company had never occurred.[1027]

The proposal did not however extend relief to transfers of trades to LLPs on the basis that pre-existing elections ensure tax free transfers of stock and work in progress and balancing charges on machinery and plant, and because the LLP 'does not provide the same level of

[1026] OTS Disincorporation Relief (n 200) 17.

[1027] OTS Disincorporation Relief (n 200) 19.

administrative savings as operating through a partnership or sole trade.' [1028] It also did not provide for the carrying over of losses, nor relief for property investment businesses – the latter due to avoidance concerns.[1029] In a follow up consultation by HM Treasury, all 13 substantive responses favoured the introduction of a disincorporation relief.[1030]

> In terms of the scope of a relief, respondents broadly supported the OTS proposals that: relief should cover tax charges on both the company and shareholders, with the former charge being more important; and relief should be available to businesses up to the EU definition of a micro-company…Respondents wanted a relief to defer any tax charge, so that the tax on any gain is due when an asset or business is eventually disposed of, not an exemption.[1031]

A form of disincorporation relief was introduced by the FA 2013[1032] applicable to transfers of business from 1 April 2013 – 31 March 2018.[1033] In addition to the 5-year sunset clause[1034] - intended to facilitate subsequent review - the relief was restricted in many significant ways. Firstly, no relief was provided for shareholder taxation, meaning that tax charges upon company distributions as part of the disincorporation were still in play. Secondly, the relief only applied to transfers of 'qualifying assets' which was limited to goodwill and interests in land not held as trading stock,[1035] though all assets of the business, other than cash,

1028 OTS Disincorporation Relief (n 200) 19.

1029 OTS Disincorporation Relief (n 200) 19.

1030 HM Treasury, Consultation on a Disincorporation Relief (n 980).

1031 HM Treasury, Consultation on a Disincorporation Relief (n 980).

1032 FA 2013, Pt 1, Ch 5 inserting TCGA 1992, ss 162B-C and CTA 2009, s 849A.

1033 FA 2013, s 58(4).

1034 FA 2013, s 58(1)(c).

1035 FA 2013, s 59(10).

had to be transferred to obtain relief in respect of the 'qualifying assets'.[1036] Thirdly, even in respect of those qualifying assets, the relief was only available where the total market value of the assets did not exceed £100,000.[1037] Fourthly, and in line with the OTS proposals, the relief did not extend to businesses converting to LLPs[1038] nor did it include any provision for carrying forward losses.

Notwithstanding initial HM Treasury estimates that approximately 610,000 companies would be eligible to claim disincorporation relief,[1039] by March 2016 fewer than 50 claims had been made. [1040] In July 2017, the OTS initiated a further consultation inviting views upon why there had been limited uptake of the relief.[1041] It considered the following as possible reasons: that few businesses actually wished to disincorporate; there was insufficient awareness of the relief; the professional and agency costs of disincorporation were too much of a barrier; the relief was too limited.[1042] The consultation responses were not published, and disincorporation relief was withdrawn for transfers taking place after 31 March 2018. In effect, disincorporation relief was tried, tested, and deemed unnecessary. However, the case for a form of disincorporation relief remains still strong, and arguably growing. The author's research suggests that in some cases the removal of the FA 2013 disincorporation relief, even though it was narrow in scope, has impacted upon the advisory process (Figure 204). 26.8%[1043] of the

1036 FA 2013, s 59(2).

1037 FA 2013, s 59(4).

1038 FA 2013, s 59(7).

1039 HM Treasury, Consultation on a Disincorporation Relief (n 980) 4-5.

1040 OTS Small Company Taxation Review (n 40) 20.

1041 OTS Disincorporation Relief – What of the Future? (n 979).

1042 OTS Disincorporation Relief – What of the Future? (n 979).

1043 92/343.

survey respondents reported that the removal of the FA 2013 disincorporation relief has made them less likely to recommend disincorporation to an owner-managed business. There is also a substantial proportion of 'don't know' responses in relation to this question (21.9%)[1044] and just 51.3%[1045] of respondents were confident that the removal of the FA 2013 disincorporation relief had not impacted upon their advisory process at all. Chartered Tax Advisors[1046] and Tax Technicians[1047] were most likely across the qualification groups to have their advisory process affected by the removal of disincorporation relief (Figure 205). A relatively high proportion (29.8%) of the most experienced respondents (more than 10 years advising) also reported that the removal of disincorporation relief had reduced the likelihood of them recommending disincorporation to an owner-managed business (Figure 206). Whilst the correlation is imperfect, a greater percentage of respondents in the two larger firm categories (11-20[1048] and more than 20[1049] accountants), as compared to the smallest two (1-2[1050] and 3-10[1051] accountants), believed that the removal of disincorporation relief had impacted upon the likelihood of them suggesting disincorporation to an owner-managed business (Figure 207).

1044 75/343.

1045 176/343.

1046 40% 'yes' (12/30).

1047 57.1% 'yes' (4/7).

1048 31.6% 'yes' (12/38).

1049 30% 'yes' (12/40).

1050 24.4% 'yes' (30/123)

1051 26.2% 'yes' (37/141).

Figure 204: Respondents' view as to the impact of the removal of disincorporation relief upon the advisory process

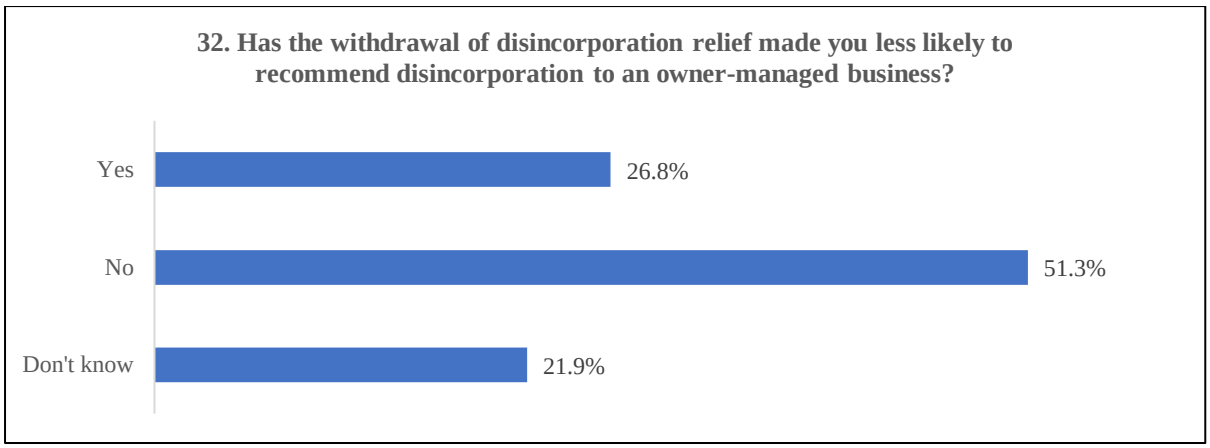


Figure 205: Respondents' view as to the impact of the removal of disincorporation relief upon the advisory process, by reference to qualification

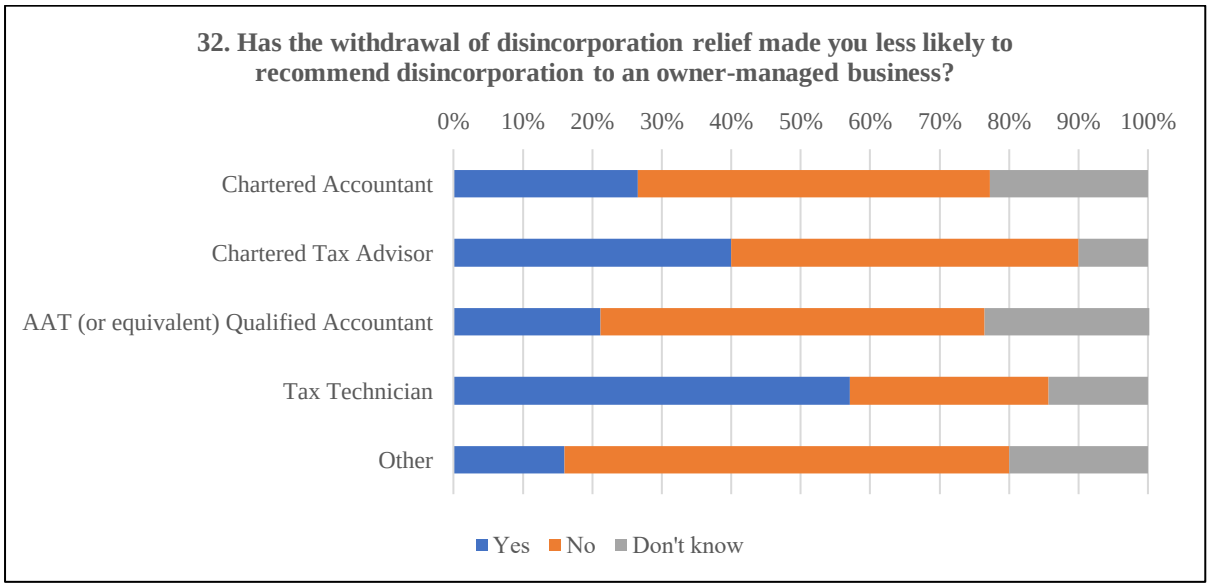


Figure 206: Respondents' view as to the impact of the removal of disincorporation relief upon the advisory process, by reference to experience

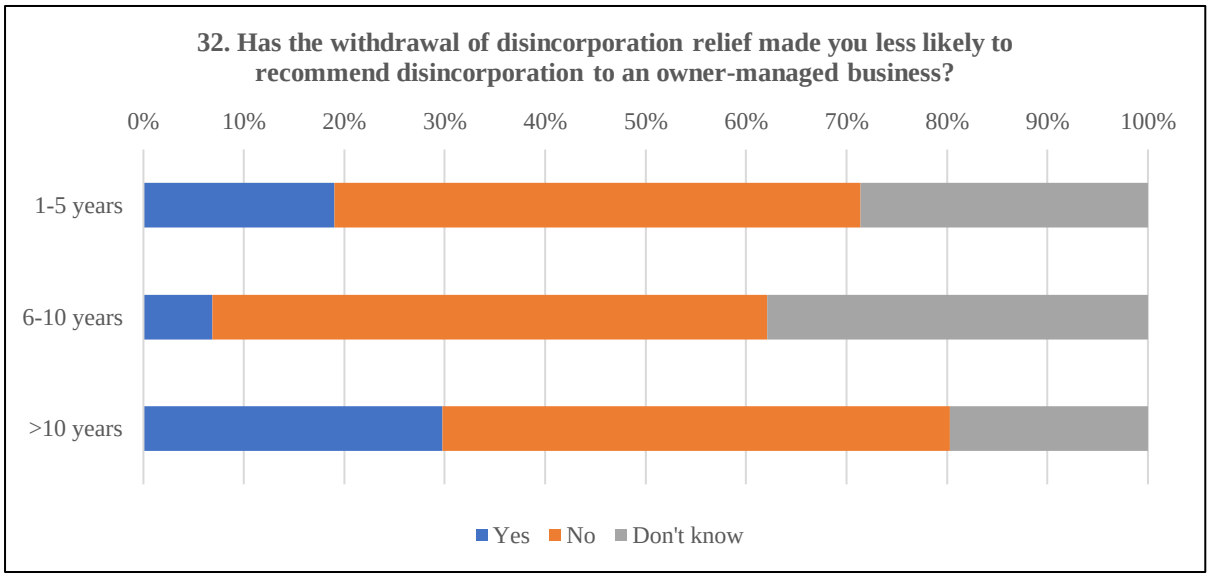
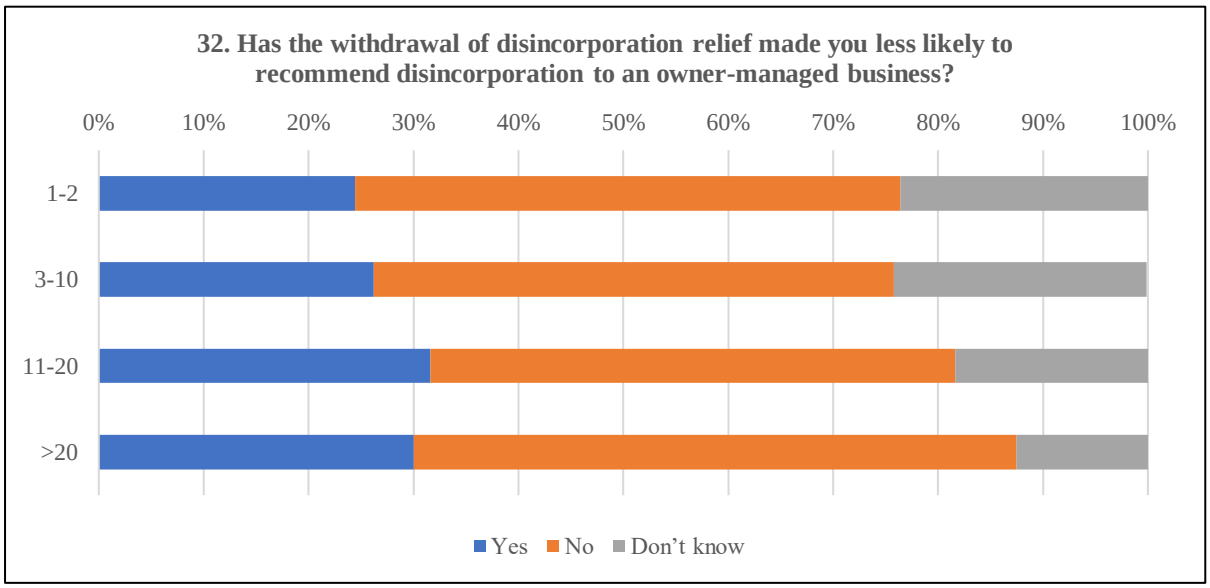


Figure 207: Respondents' view as to the impact of the removal of disincorporation relief upon the advisory process, by reference to firm size



Overall, this data confirms that the theoretical lock-in effects of the capital taxation of disincorporation are, for some owner-managers, likely to be very real – the removal of even a

very limited form of relief has generated more hesitance in advising disincorporation for some. The reintroduction of a disincorporation relief, particularly a less restricted one, would go a long way towards mitigating such effects.

Objections to the introduction disincorporation relief based upon the expansion of the tax code i.e. additional complexity, and exchequer costs have already been appropriately addressed by the OTS.

> If the tax system is getting in the way of business doing what it wants to do, or adding burdens to valid business choices, those are complexities. Developing ways to remove or circumvent the tax barrier is a simplification [even though introducing a relief would add a few additional pages to the already lengthy tax code]...The tax cost is an interesting question but as this is to facilitate the smallest businesses managing what they do more easily, we think that any tax cost – which we think will in any event be modest – should be seen as an investment in this vital sector.[1052]

The more difficult matter is whether the limited uptake of the FA 2013 disincorporation relief can be taken to reflect upon the desirability or necessity of its existence. It would be misleading from the outset to expect that the 610,000 companies potentially eligible for the disincorporation relief offered by FA 2013 would all be attracted to disincorporation. Some will have had good commercial reasons for operating through a company (see Chapter 2), others might not but nonetheless find the associated tax advantages a sufficient reason to retain the company form. Taking the OTS' research as a starting point, the 'small but significant' 14% looking to possibly disincorporate amounts to approximately 85,400 businesses;[1053] this assumes that the percentage estimate carries over to the eligible businesses identified by HM Treasury, which may not necessarily be the case – it is possible that all of the 14% surveyed

[1052] OTS Disincorporation Relief (n 200) 3.

[1053] OTS Disincorporation Relief (n 200) 5.

would not be eligible under the FA 2013 scheme. The relief was never going to attract large numbers of claims, but it is also reasonable to expect that more than 50 claims would have been made in the first three years of operation. Accounting for the limited uptake is critical in understanding the proper path forward.

Both OTS[1054] and HMRC[1055] research confirmed the existence of an appetite for disincorporation (and associated relief) prior to the passage of FA 2013. As suggested by the OTS, one possible manner of accounting for the lack of uptake of disincorporation relief when it was available is simply to demonstrate that businesses did not actually wish to disincorporate. Perhaps the beneficial tax treatment of the company form was too much of a driver to retain corporate status after all.[1056] However, the OTS' follow up consultation in July 2017 confirmed that at least anecdotally the desire for owner-managed companies to disincorporate was still present.[1057] There were also no material legal or regulatory changes reducing the administrative burdens endured by company owner-managers throughout the consultation and enactment periods that would make retention of the corporate form more attractive than was previously the case. It is extremely unlikely that the desire to disincorporate simply disappeared throughout the short lifespan of the FA 2013 disincorporation relief, or that the respondents to both initial studies were seriously misguided. Admittedly, as the OTS posited, it may be that a small number of possible beneficiaries encountered the non-tax barriers to disincorporation and found those to be too burdensome, but that is no reason for a tax system to operate as an additional barrier. If this is incorrect, and the desire to disincorporate did wane, the subsequent

1054 OTS Disincorporation Relief (n 200).

1055 HMRC Reasons Behind Incorporation (n 25).

1056 OTS Small Business Tax Review Interim Report (n 273) 31.

1057 OTS Disincorporation Relief – What of the Future? (n 979) 3.

reduction of the dividend allowance and increased application of the IR 35 rules means that the original OTS 'target audience' - those finding that the administrative burdens outweigh the tax advantages of the corporate form - is today likely to be larger than ever. Any further moves to align the tax treatment of companies and unincorporated businesses (likely with employees too), along the lines proposed by Adam and Miller, will generate further stimulus for potential disincorporation. The reintroduction of a disincorporation relief is therefore essential to facilitating the proper selection of business form, particularly if the tax benefits of the corporate status are reduced or removed. In any event, the fact that disincorporation relief may only be relevant or attractive to a small number of claimants cannot be used to undermine the basic demand of equity and neutrality; if incorporation is CGT free,[1058] then disincorporation ought to be so too. The case for relief stands.

The final form of the FA 2013 disincorporation relief was much narrower than that initially envisaged by the OTS, thereby inevitably restricting its utility, and consequently the number of claims made. The absence of shareholder relief is striking, and seemingly without any rationale beyond potential cost savings for the exchequer – note that the author's research indicates that both the company and shareholder tax charges upon disincorporation had broadly equal disincentive effects (Parts 5.2.1 and 5.2.2 above). Furthermore the £100,000 limit was 'quite often an early knockdown barrier to consideration of the relief, particularly where non-purchased goodwill is involved.' It also 'rule[d] out companies that own even modest amounts of land or properties.'[1059] The supposed justification for restrictions in relation to qualifying assets and the qualifying threshold was to 'keep the relief simple and reduce the need for anti-

[1058] TCGA 1992, s 162.

[1059] OTS Small Company Taxation Review (n 40) 20.

avoidance legislation.'[1060] In relation to the former, limiting the scope of qualifying assets actually adds an element of complexity to the relief – one is tasked with determining which assets fit the bill, and whether the relief is worth claiming in respect of them, rather than being able to assume that all business assets transferred qualify for the relief. A better, more equitable, solution would be to mirror the section 162(1) TCGA 1992 provisions, which offer full relief where the whole of the assets of the business (not including cash) are transferred to the new form. Omitting an upper-limit threshold in a new disincorporation relief would also be an equitable simplification of the old regime. A broader form of disincorporation relief would result in a greater cost to the exchequer, but this should still be seen as an investment in the small business population – an investment in furtherance of equity, neutrality, and economic efficiency. The overall cost is still likely to be modest, as initially predicted by the OTS, but it could ultimately be recovered as part of overall rate alignment across business forms. Avoidance concerns must, of course, be addressed, but legislative changes made since FA 2013 should assist in preventing the utilisation of disincorporation as a means to gain an unwarranted tax advantage. Section 396B ITTOIA 2005 (discussed in relation to the taxation of shareholders: Part 5.2.2 above) is specifically targeted at phoenixing arrangements entered into with a view to avoiding or reducing charges to income tax. In addition, section 26 Finance Act 2015[1061] prevents 'flip-flopping' between business forms with the purpose of amortising post-2002 goodwill.[1062] If in doubt, a 'belt and braces' targeted anti-avoidance rule similar to that in effect in section 396B ITTOIA 2005 could be included in legislation enacting a new form of disincorporation relief. Avoidance risks should serve as a warning to draft clear and comprehensive legislation, rather than act as a justification to introduce arbitrary restrictions

[1060] OTS Disincorporation Relief – What of the Future? (n 979) 3.

[1061] Amending CTA 2009, Pt 8.

[1062] OTS Disincorporation Relief – What of the Future? (n 979) 3.

upon a warranted form of relief. In short, a disincorporation relief mirroring the section 162 TCGA 1992 incorporation relief is a sensible way to proceed.

Denying relief in the event of a transfer of business from the company to an LLP is also an untenable restriction. Stating that disincorporation relief ought not to be available for LLP conversions because they do not offer administrative savings to the same extent as unincorporated forms fails to give due consideration to other important principles at stake. Disqualifying LLP conversions from the scope of relief has the potential to distort the selection of form, by locking owner-managers into the company structure when the LLP might be deemed more suitable; this conflicts with the underlying need for business form neutrality, and the associated inefficiency generates deadweight economic losses. Administrative costs associated with the running of an LLP should be a factor in considering whether the form is viable from an economic perspective but is not a good reason to impose a tax penalty upon conversion where it does not exist for transfers to unincorporated businesses. The section 162 TCGA 1992 incorporation relief is applicable to LLP-company conversions, so likewise any disincorporation relief should extend to company-LLP conversions. To do otherwise would also undermine the commitment of the UK tax system to treat trading partnerships and trading LLPs alike for tax purposes.

On a more practical level, the OTS point as to lack of awareness in relation to the FA 2013 disincorporation relief also has to be taken seriously. If one does not know of the existence of a relief, then one cannot be expected to claim it, and this certainly appears to have been an issue in the past. The HMRC Reasons Behind Incorporation Report highlighted the 'generally low awareness of disincorporation relief.'[1063] It also indicated that the target audience of the

[1063] HMRC Reasons Behind Incorporation (n 25) 58.

FA 2013 disincorporation relief were insufficiently informed as to its availability: 'those who agreed that administration is too much of a burden were *less* [emphasis added] likely to be aware of disincorporation relief (nine per cent being aware of the relief vs. sixteen per cent of those who disagreed administration is too much of a burden).'[1064] Furthermore, it appears that it is not just the owner-managers that lacked awareness:

> [w]e [the OTS] continue to hear of a lack of awareness among *advisors and businesses* [emphasis added] of the relief, and given the limited take-up, it is clear there will be limited experience of it in practice. This may in turn mean the administrative or advisory costs of taking advantage of it are not commensurate with the benefits of making the change or the amount of relief involved.[1065]

This serves to prove that it is essential to ensure adequate publicity of available reliefs to both businesses and their advisors. The former might appear difficult but can be targeted by way of email – it is already HMRC practice to send out information in relation to keeping adequate records and the claiming of allowances, and so the associated administrative costs will be minimal. It also lends weight to the argument that the previous election requirement should not be replicated in any subsequent iteration of disincorporation relief. This would reduce the extent of required professional assistance, thereby reducing compliance costs (even if only to a minimal extent) and is symmetrical with the section 162 TCGA 1992 incorporation relief, which is automatically applicable and need not be claimed. Equity, neutrality, economic efficiency and the reduction of compliance and administration costs are all furthered by the removal of the election requirement, though any new form of relief should still be adequately advertised to all interested parties.

1064 HMRC Reasons Behind Incorporation (n 25) 58.

1065 OTS Disincorporation Relief – What of the Future? (n 979) 3.

5.3 CHAPTER CONCLUSION

The present application of tax charges to the disincorporation of businesses is, overall, extremely difficult to justify. Unfortunately, there are owner-managed companies in existence today because of a poorly informed choice to incorporate. This decision may have been attributable to mistaken beliefs about the necessity of incorporation (see Chapter 2) or associated with a tax-motivated gamble (some of whom will have lost). No doubt there are others that have found the corporate form unsuitable for their business operations. In such cases, the tax system should not operate as a barrier to a commercially orientated decision to disincorporate. Indeed, the lock-in effects of the present tax regime run counter to the key principles of horizontal equity, neutrality and economic efficiency, and the asymmetrical treatment of incorporation and disincorporation respectively is striking. The solution is the introduction of a relief mirroring section 162 TCGA 1992, which ensures that any potentially significant capital tax charges do not arise upon incorporation – note that there is no upper limit applied to this relief; the same should be carried over to disincorporation. It is essential that any new form of disincorporation relief goes further than the previous regime, by ensuring that both the company and its shareholders do not suffer any adverse tax consequences upon disincorporation. It should be extended to company-LLP transfers of business, to ensure neutrality between ordinary partnerships and LLPs which is already a fundamental aspect of the tax system. Whilst the potential for avoidance is always a legitimate concern, any tax-motivated disincorporation should be adequately dealt with by pre-existing anti-avoidance mechanisms (see Part 5.2.3 above). In the event of uncertainty, the matter could also be addressed with the introduction of a new targeted anti-avoidance rule. The avoidance capacity is limited and is certainly not a reason to abandon this relatively simple (and critical) reform.

5.4 THESIS CONCLUSION

In many ways, and perhaps somewhat surprisingly for a non-taxation focused text, this thesis is well summarised by two short quotes extracted from *Gower's Principles of Modern Company Law:*[1066]

> [i]n closely-held companies, where…personal guarantees to large lenders may negate the benefits of limited liability, tax considerations will play a significant role in determining whether or not to incorporate the business…
>
> [c]ompanies [may be] formed to enable…a small body of partners to carry on a business… in such cases, the company is often a tax-efficient substitute for the partnership.

And so, the partnership has suffered at the hand of the non-neutral tax system.

This thesis has presented empirical research in support of the above statements. Recall that the respondents to the author's survey confirmed that the ordinary partnership still has a genuine commercial attraction for owner-managed businesses offering the benefits of: easy set up; high levels of privacy; a high degree of personal control; flexibility; easy dissolution; and low administration and compliance costs. That is not to say that the company is not also a viable form for many owner-managed businesses, and the draw of *inter alia* limited liability, is no doubt a weighty consideration (though alone insufficient to make the LLP an attractive business form which has suffered from over-complexity since its introduction). The problem particularly arises in the instances where limited liability is illusory, with the prevalence of personal guarantees having been confirmed by the respondents to the author's study. In such instances, owner-managers may be lured in on a false premise.

[1066] Gower (n 30) 50, 13 (presented in that order).

In any event, the author has also presented data establishing that, relatively speaking, companies are perceived by the accountancy profession as tax advantageous (93.9% agreed), and partnerships as tax disadvantageous (83.3% agreed). The cross-tabulated data highlights that tax efficiency also influences the likelihood of advisors endorsing a particular business form which will, in turn, affect its use by owner-managed businesses. The comparative tax treatment of partnerships and companies demonstrates that, in profit-making enterprises, there are real savings to be made by operating as a company. Taking into account the rise of the gig economy and income splitting opportunities, the partnership is most likely to be affected by this distortionary treatment. Crucially, this evidence provides further impetus to pursue reforms such as those proposed by Adam and Miller: the tax system is fundamentally broken from a neutrality and equity perspective, and partnerships will continue to be the ugly duckling of business forms until remedial steps are taken.[1067] The author is also of the opinion that, as part of this reform process, a disincorporation relief is a simple and essential step on the road to the neutral taxation of business forms.

[1067] See Annex E (thesis postscript) for a possible more radical approach.

ANNEX A: PARTNERSHIPS AND COMPANIES[1068]

A1. ORDINARY PARTNERSHIPS

A1.1 England & Wales

Since 1 January 1891, the PA 1890 has formed the basis of the law of partnership in the UK (applying to both Scottish and English partnerships, though Scotland has its own additional provisions). The Act itself was largely declaratory of the pre-existing law[1069] and only sought to provide a basic, rather than comprehensive, code. 'Partnership' is defined in section 1(1) PA 1890 which states that a partnership is 'the relation which subsists between persons carrying on a business in common with a view of profit.' Companies and LLPs are excluded from the definition of partnership by operation of section 1(2) PA 1890 and section 1 LLP Act 2000.[1070] It is common to refer to an ordinary partnership as a 'firm', and those terms are used interchangeably.

Whilst establishing the existence of a partnership can, on occasion, be difficult, the PA 1890 provides some characteristic hallmarks of the partnership:

(a) the participation of every partner in the management of the business, unless otherwise agreed by them (section 24(6));

1068 Limited Partnerships, as regulated by the LPA 1907, are excluded from consideration owing to the fact that their primary use is as a vehicle for venture capital projects.

1069 Which is preserved by PA 1890, s 46 'except in so far as they [the previous rules] are inconsistent with the express provisions of the Act'. partnerships law and was not intended, nor does it purport to be, a complete code. The Act contains no provisions relating to goodwill, the administration of assets upon death or bankruptcy of a partner, nor the manner in which proceedings can be brought against a partnership. Indeed, the existence of a partnership still depends upon a relationship which results from contract, which may be express or inferred from the parties' conduct based on ordinary contract rules.

1070 Though some aspects of partnership law are, by exception, applicable to LLPs (see Chapter 3).

(b) the joint liability of every partner for the debts of the partnership to the whole extent of his/her property (section 9);

(c) a proportionate contribution by each partner, in line with his/her share of the profits, to the payment of the debts of the business (section 24(1));

(d) the agency of every partner, within the ordinary scope of the business, for the whole partnership (sections 5-6);

(e) a personal and fiduciary relation between the partners so that, for example, no one of them can put a stranger in his/her place without the consent of the others (section 24(7)).

As mark (e) suggests, once it has been established that a partnership does exist, the partnership is no longer governed solely by the law of contract. Instead, partnership law is truly an amalgamation of contract law, statute law and equitable principles.

A1.2 Scotland

Scottish partnerships operate largely in the same manner as English partnerships since they are equally governed by the PA 1890. However, there is one significant difference; Scottish partnerships have legal personality. This reflects the fact that, historically, Scottish law developed along the same lines as the *lex mercatoria* rather than following the common law.[1071] Section 4(2) PA 1890 preserves this historical difference and provides that '[i]n Scotland a firm is a legal person distinct from the partners of whom it is composed'.

[1071] William Holdsworth, *A History of English Law*, Vol V, p.84, Vol VIII (Sweet & Maxwell 1945) 194-8; Martyn Jones and Simon Mackintosh, *Revenue Law in Scotland* (Butterworths 1986), 152.

A2. LIMITED LIABILITY PARTNERSHIPS

Limited Liability Partnerships are the creation of the LLP Act 2000. The background to the legislation and a comparison with ordinary partnerships is contained in Chapter 3.

A3. COMPANIES

The word 'company' is generally used interchangeably with 'corporation' and is typically understood as referring to a company formed by registration under the CA 2006 or earlier such Acts. The principal distinguishing features of a company are that it has legal personality separate from that of its shareholders and offers to them the benefit of limited liability. Section 1 CA 2006 defines a 'company' as one formed and registered under the Act 'unless the context otherwise requires'. The Act recognises four basic types of company:

1. A private company limited by shares;[1072]
2. A public company limited by shares;[1073]
3. A private company limited by guarantee;[1074]
4. An unlimited company;[1075]

There are other forms of corporation: those created by their own special Act of Parliament or by Royal Charter; the monarch and bishops of the Church of England. The owner-managed

[1072] CA 2006, s 3(2).

[1073] CA 2006, s 4(1).

[1074] CA 2006, s 3(2).

[1075] CA 2006, s 3(3).

business is expected to utilise the first structure (a private company limited by shares) and any references to ‘company’ in the thesis are to be construed accordingly.

For taxation purposes the definition of ‘company’ is broader. Pointon and Spratley note that ‘[a]lthough it should be reasonably clear to the reader that limited liability companies are chargeable to corporation tax, the legislation [often] casts a rather wider net’.[1076]

[1076] Pointon and Spratley (n 356) 205.

ANNEX B: RESEARCH METHODOLOGY[1077]

A total of 4,000 accountancy firms were directly contacted and invited to participate in a pre-piloted[1078] online survey through the Joint Information Systems Committee platform ("**JISC**", formerly known as Bristol Online Surveys).[1079] The survey was also kindly advertised by the Chartered Institute of Taxation ("**CIOT**"), which originally presented a bias concern, but it was believed to be helpful to maximise the pool of potential respondents. Participants were asked to indicate where they heard about the survey. This could be used to identify any potential bias in the event that a disproportionate number of responses were received as a result of the CIOT advert. Cross-tabulation of responses would have enabled any significant differences in opinion to be revealed. In any event, only 2 respondents indicated that the CIOT advertising had linked them to the survey, so no further analysis was necessary. JISC was also paid to promote the survey to a general target audience of accountants which appears to have generated 3 responses, though it is possible that 'online advert' may have been ticked as a contact method by those obtaining information from the CIOT. Most of the responses (96.7%)[1080] were generated by email invitations that were sent at various points throughout April – June 2020. A total of 362 responses were received, though one contained no data leaving 361 available for analysis.

1077 This research was granted ethical approval by the University of Oxford Social Sciences and Humanities Inter-Divisional Research Ethics Committee under reference R65701/RE002.

1078 Only 5 responses were received on the pilot survey which was conducted at the beginning of March 2020 – just before the national lockdown - but the feedback sufficed to indicate areas where the survey needed streamlining to make it more user friendly. The poor response may partly be because those invited to participate were told that the survey was in pilot form. There were no significant changes to the substance of the questions. Pilot responses are excluded from the findings.

1079 JISC Survey Platform <https://www.jisc.ac.uk/> accessed 3 April 2022.

1080 348/361.

The email sample included both incorporated and unincorporated firms. 2,986 of the incorporated firms contacted were randomly sampled from the Companies House Register, following a search filtering companies listing 69201 (Accounting) as their primary Standard Industrial Classification code.[1081] Companies listed as dormant, in liquidation, administration or voluntary arrangements, along with those with no accounts filed, limited by guarantee and community interest companies were excluded from the sample on the basis that responses were unlikely to be forthcoming and/or unhelpful. Companies based at the same registered address were assumed to be duplicates so the sample was reduced to contain just one firm per registered address. Companies based in Northern Ireland were also removed from the sample.[1082] Details of the unincorporated firms were obtained from a random sample of information contained on multiple websites advertising accountancy services.[1083] These sources were used to ensure the inclusion of accountancy firms operating through different legal forms. Of this sample, it appears (the form classification may contain errors) that a further 445 companies (making a total of 3,341), 98 LLPs, 466 sole traders and 5 partnerships were contacted.

In an attempt to increase the number of responses, where firms listed individual email addresses for their accountants each accountant was contacted separately. This was the case for 1,153 of the sample firms which accounted for 3,699 of emails sent. The total number of email invitations was 6,546 for the 4,000 firms. There was a risk that this would result in larger firms being overrepresented in the data set. Accordingly, respondents were asked to indicate, in range form, how many accountants worked for their firm. This risk did not materialise, as

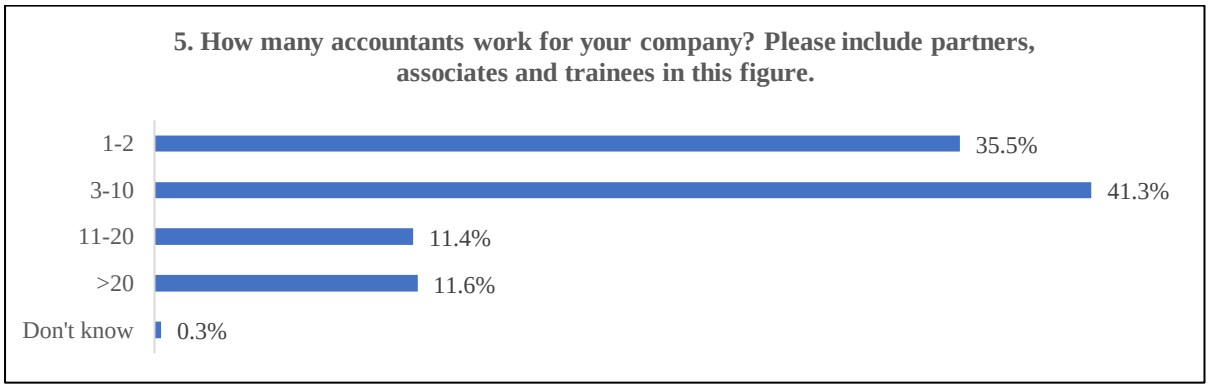
1081 42,544 companies.

1082 The author's initial sample from the Companies House Register was 4,000. The 2,986 eventually contacted were those with accessible contact details remaining after the cuts.

1083 The following websites were used to locate accountants: www.192.com**;** www.yell.com**;** www.findanaccountant.co.uk**;** www.local-accountants-uk.co.uk; www.icaew.com. All accessed 3 April 2022.

76.8% (277) of the responses came from firms with less than 10 accountants. 35.5% (128) of the responses were received from firms with just 1-2 accountants.

Figure A1: Percentage of responses based on firm size



The high proportion of small firm participants is not surprising since, 'it is clear that the size profile of accountancy firms is similar to that of enterprise as a whole, with a few big organisations and a myriad of small firms.'[1084] At times, firm size does appear to correlate with differences in opinion on some of the questions posed. This is duly highlighted in the presentation of findings.

230 emails were bounced back, with the majority indicating that this was as a result of a spam filter. Some respondents sought further personal assurances before filling in the survey, expressing a hesitation to click a link on an unsolicited email. Details of supervisors as well as a phone number were provided to assist with this. In terms of response rate, the figures vary

[1084] Institute of Chartered Accountants for England & Wales, *The 99.9%: small and medium-sized businesses, who are they and what do they need?'* (2014), 17 fn 11 <https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/small-business-matters/the-99-percent-small-and-medium-sized-businesses.ashx> accessed 3 April 2022. Based upon the fact that in 2013, the Accountancy Age list of top 100 firms contained 20 firms that had less than 10 partners. In the same year, the ONS reported that 36,015 enterprises were engaged in accounting, auditing and bookkeeping activities.

dependent on the calculation method. Based on the number of emails sent the response rate is 5.5%, or 5.7% if bounced emails are excluded. This increases to a 9% response rate if based on the number of firms contacted, rather than emails sent. Whilst the response rate is low, enough responses were generated so as to provide a helpful working data set. Overall, it is highly likely that the increased workload for accountants as a result of the COVID-19 pandemic affected the response rate. Attempts were made to mitigate that affect by sending invitations on numerous different dates throughout the period. A number of those invited to take part in the survey indicated that they did not have the capacity to participate.

Responses were received from accountancy firms representing all geographical regions in the UK. 7 questionnaires were completed by respondents based in Scotland, which is unique in treating the partnership as a legal person distinct from the partners of whom it is composed.[1085] Accordingly, the Scottish responses are considered separately in the findings where it appears appropriate to do so. In any event, the number of Scottish responses is low (1.9%)[1086] and so does not have any significant distortionary effects on the overall findings. There is an overrepresentation of accountancy firms based in the South East and London (including Greater London), comprising 38.3%[1087] of the total responses, but this is broadly consistent with the distribution of all private sector businesses in the UK.[1088]

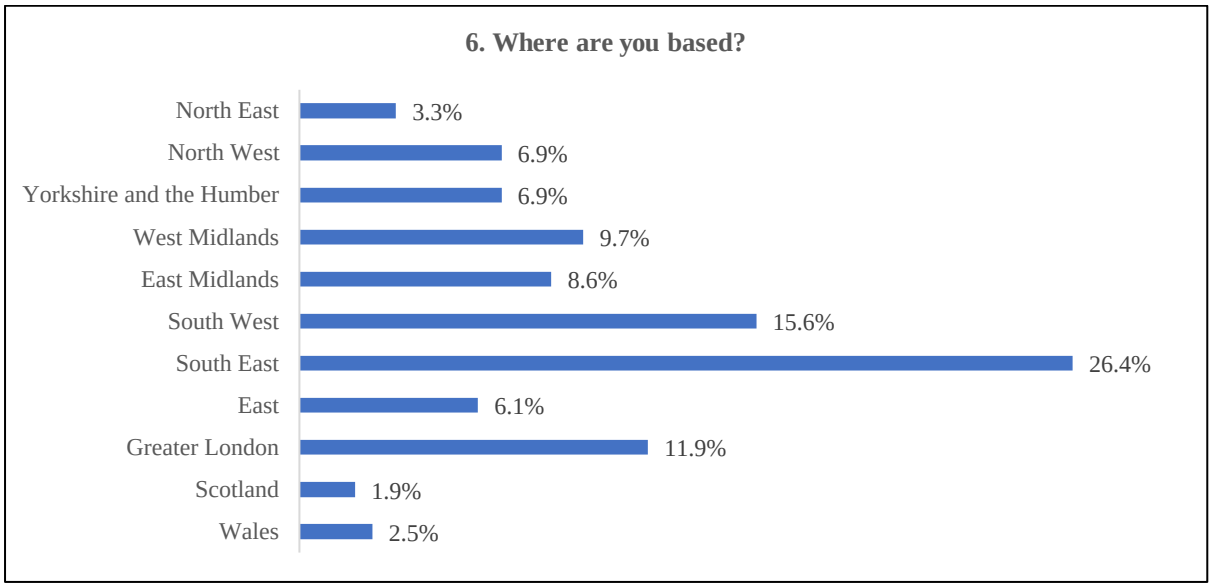
1085 PA 1890, s 4(2).

1086 7/361.

1087 138/361.

1088 Business Population Estimates 2020 (n 3) 10. 35% (2,040,000) of all UK businesses were based in London and the South East. Note also that the North East had the least of any English region (163,000 private sector businesses) which is also consistent with the distribution of the response data.

Figure A2: Percentage of responses based on location



After confirming that they were currently offering owner-managed businesses[1089] advice in relation to legal form, the respondents were asked how long they had personally been providing this advice for and to indicate their level of qualifications. As can be seen in Figures A3 and A4 below, the overwhelming majority of respondents (84.7%)[1090] had been providing advice for more than 10 years, and most respondents described themselves as 'Chartered Accountants'. The CIOT specifically requested the inclusion of 'Chartered Tax Advisor' and 'Tax Technician' in the belief that most of their members would describe themselves in this way.

1089 The following definition of owner-managed businesses was provided: 'a business that has no employees or one which only employs the owner(s) and their family/friends.'

1090 306/361.

Figure A3: Percentage of responses based on experience

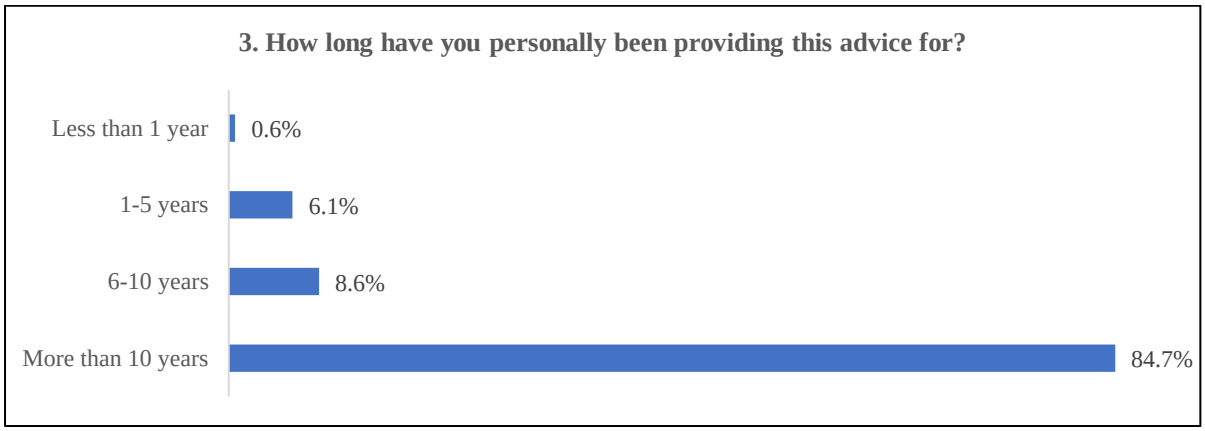
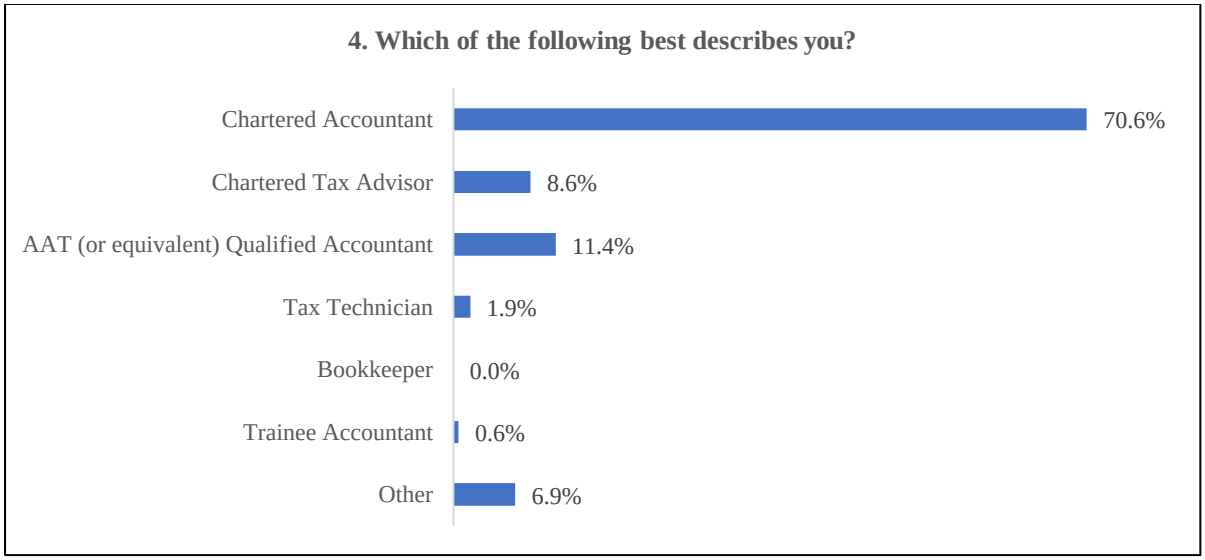


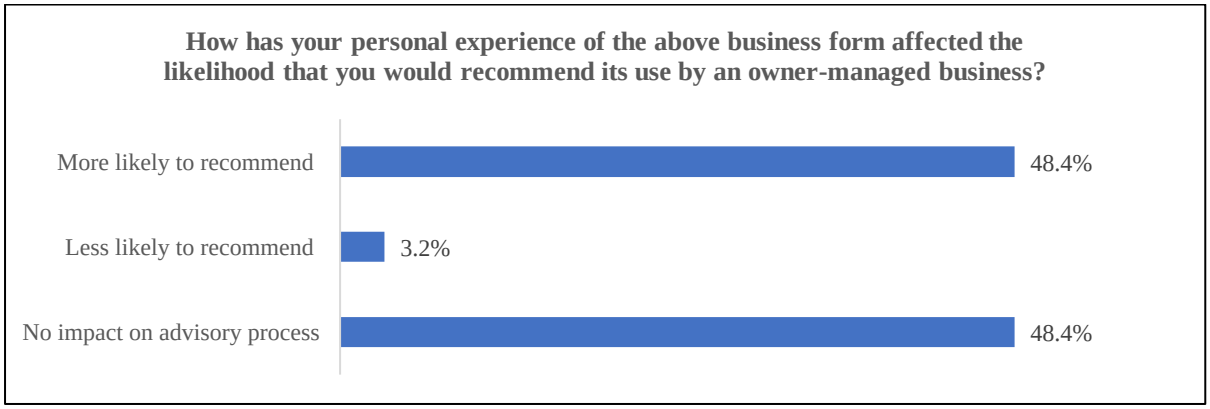
Figure A4: Percentage of responses based on qualifications



Based on the additional information provided, it appears that at least one of those ticking 'Other' was a Chartered Management Accountant. Instances where experience and qualifications appear to correlate with a difference in response are indicated in the presentation of the data.

As part of the follow-up corrective survey,[1091] the author took the opportunity to explore how the accountants' personal experience of business forms may impact upon the advisory process. A question as to the operational business form was omitted from the original survey, as at the initial point of distribution it was unclear whether the author would be able to contact unincorporated accountancy firms in any substantial numbers; the survey was originally distributed to companies only. 48.4%[1092] of the respondents indicated that their own experience of business form made them more likely to recommend it to an owner-managed business; an equal amount said the advisory process was unaffected. One respondent, operating as a company, was less likely to recommend it due to their own personal experience. This would be an interesting point for more detailed exploration in future studies.

Figure A5: Impact of personal experience on business form advice



1091 Annex D.

1092 15/31.

ANNEX C: ORIGINAL SURVEY



Advising Owner-Managed Businesses in Relation to Form - Accountants

Information and Privacy Notice

Investigating the Decision-Making Process Involved in Advising Small Businesses as to Appropriate Business Form

General Information

The aim of this study is to gather data that offers insight into how certain factors affect the likelihood of small businesses being advised to adopt different business forms. This is part of a wider research project investigating the use of partnerships by small businesses.

I appreciate your interest in participating in this online survey. You have been invited to participate as you have been identified as someone with experience of advising small businesses in relation to form. Please read through these terms before participating in the survey. You may ask any questions before taking part by contacting the researcher (details below).

The survey will ask a few background questions and then specific questions about advising in relation to business forms. The survey should take **approximately 8 - 12 minutes**. *At any point the survey may be paused and finished at a later time.*

Do I have to take part?

Please note that your participation is voluntary. You may withdraw at any point during the questionnaire for any reason, before submitting your answers, by closing the browser.

How will your data be used?

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Survey responses will be anonymous and I will use all reasonable endeavours to keep them confidential. The survey does invite you to leave contact details at the end for the purpose of follow-up interviews, though there is no obligation for you to do so. All respondents will remain anonymous in data published based upon the responses to this survey, even if contact details are provided.

Your data will be stored in encrypted files and may be used in academic publications. Your IP address will not be stored. All questions are optional. Research data will be stored for a minimum of three years after publication or public release.

Who will have access to your data?

JISC Online Surveys and the University of Oxford are the data controllers with respect to your personal data and, as such, will determine how your personal data is used. Please see JISC's privacy notice here: https://www.jisc.ac.uk/website/privacy-notice. JISC Online Surveys will only share anonymised data with the University of Oxford, for the purposes of research.

Further information about your rights with respect to your personal data is available from https://compliance.web.ox.ac.uk/individual-rights.

I would like your permission to use your anonymised data from this survey in future studies, and to share data with other researchers (e.g. in online databases). Any personal information that could identify you will be removed or changed before files are shared with other researchers or results are made public.

Responsible members of the University of Oxford and funders may be given access to data for monitoring and/or audit of the study to ensure we are complying with guidelines, or as otherwise required by law.

This questionnaire is for a DPhil project. The principal researcher is Sophie Chandler-Millington who is attached to the Faculty of Law at the University of Oxford. This project is being completed under the supervision of Mr Edwin Simpson and Professor Judith Freedman.

This project has been reviewed by, and received ethics clearance through, the University of Oxford Central University Research Ethics Committee [Reference number: R65701/RE001].

What if there is a problem?

If you have a concern or questions about any aspect of this project, please speak to the researcher Sophie Chandler-Millington (sophie.millington@chch.ox.ac.uk) or their

principal supervisor Mr Edwin Simpson (edwin.simpson@chch.ox.ac.uk), who will do their best to answer your query. We should acknowledge your concern within 10 working days and give you an indication of how we intend to deal with it. If you remain unhappy or wish to make a formal complaint, please contact the Chair of the relevant Research Ethics Committee at the University of Oxford:

Chair, Social Sciences & Humanities Inter-Divisional Research Ethics Committee;

Email: ethics@socsci.ox.ac.uk;

Address: Research Services, University of Oxford, Wellington Square, Oxford OX1 2JD

The Chair will seek to resolve the matter in a reasonably expeditious manner.

Please note that you may only participate in this survey if you are 18 years of age or over. If you have read the information above and agree to participate with the understanding that the data (including any personal data) you submit will be processed accordingly, please click to the next page to get started.

Please confirm that you are over the age of 18 before proceeding to participate in this survey. ** Required*

- ○ Yes

Background Information

Please confirm that you are currently involved in advising owner-managed businesses in relation to legal form: * *Required*

More info

- ○ Yes

If not, please disregard this questionnaire and close your browser.

How long have you personally been providing this type of advice for?

- ○ Less than 1 year
- ○ 1 - 5 years
- ○ 6 - 10 years
- ○ More than 10 years

Which of the following best describes you?

- ○ Chartered Accountant
- ○ Chartered Tax Advisor
- ○ AAT (or equivalent) Qualified Accountant
- ○ Tax Technician
- ○ Bookkeeper
- ○ Trainee Accountant
- ○ Other

If you selected Other, please specify:

How many accountants work for your firm/company? *Please include partners, associates and trainees in this figure.*

- 1 - 2
- 3 - 10
- 11 - 20
- >20
- Don't know

Where are you based?

- North East
- North West
- Yorkshire and the Humber
- West Midlands
- East Midlands
- South West
- South East
- East
- Greater London
- Scotland
- Wales

Companies

Have you ever **advised** an owner-managed business to form a company?

- ○ Yes
- ○ No

To what extent do you agree that the following are advantages of forming/operating through a company for owner-managed businesses?

	Strongly agree	Agree	Disagree	Strongly disagree	Don't know
Limited liability	○	○	○	○	○
Financing options e.g. ability to offer floating charges	○	○	○	○	○
Separate and continuing legal personality	○	○	○	○	○
Pension flexibility	○	○	○	○	○
Formal business structure	○	○	○	○	○
Prestige/credibility	○	○	○	○	○
Ability to satisfy customer requirements	○	○	○	○	○
Ability to sell/transfer shares	○	○	○	○	○
Tax treatment	○	○	○	○	○

Please specify any other important advantages (if applicable).

To what extent do you agree that the following are disadvantages of forming/operating as a company for owner-managed businesses?

	Strongly agree	Agree	Disagree	Strongly disagree	Don't know
Expensive and complicated to set up	○	○	○	○	○
Costly administrative/compliance burdens	○	○	○	○	○
Inflexible business structure	○	○	○	○	○
Formality requirements for dissolution	○	○	○	○	○
Lack of privacy	○	○	○	○	○

Please specify any other significant disadvantages (if applicable).

In your view, how important are the following tax considerations for owner-managed businesses?

	Very important	Quite important	Not important	Don't know
Income/corporation tax rates on profits paid to owner(s)	○	○	○	○
Corporation tax rates on retained profits (if a company)	○	○	○	○
Availability of R&D tax relief	○	○	○	○
Income shifting ability	○	○	○	○
National insurance rates	○	○	○	○
Capital gains tax planning	○	○	○	○

Inheritance tax planning	○	○	○	○

Please specify any other important tax considerations (if applicable).

Companies

Which of the following types of owner-managed business have you advised to form a company? *Please tick all that apply.*

- ☐ Agricultural
- ☐ Construction
- ☐ Manufacturing
- ☐ Wholesale and retail trades
- ☐ Motor vehicles and motorcycle repairs
- ☐ Accommodation and food service activities
- ☐ Transport (including taxis)
- ☐ Medical
- ☐ Other health, educational and social services
- ☐ Professional, financial and technical services
- ☐ Information, communication and technology
- ☐ Real estate activities
- ☐ Other

If you selected Other, please specify:

In your view, how important is limited liability to owner-managed businesses operating in the following sectors?

	Very important	Quite important	Not important	Don't know
Agricultural	○	○	○	○
Construction	○	○	○	○
Manufacturing	○	○	○	○

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Wholesale and retail trades	○	○	○	○
Motor vehicles and motorcycle repairs	○	○	○	○
Accommodation and food service activities	○	○	○	○
Transport (including taxis)	○	○	○	○
Medical	○	○	○	○
Other health, educational and social services	○	○	○	○
Professional, financial and technical services	○	○	○	○
Information, communication and technology	○	○	○	○
Real estate activities	○	○	○	○

Please specify any other business sectors in which you believe limited liability is important (if applicable).

In your experience, how often are business owner-managers (or their family members) required to sign indemnity agreements, or secure business debts against their personal assets, by banks or other creditors?

- ○ Very often
- ○ Often
- ○ Not often
- ○ Rarely / never

Does the practise of requiring personal guarantees reduce the likelihood of you advising a small business to adopt a corporate form?

- ○ Yes
- ○ No
- ○ Don't know

Have you ever **formed** a company on behalf of your owner-managed business client(s)?

- ○ Yes
- ○ No

How much would you typically charge an owner-managed business to assist with the formation of a company? *You may provide a range if it assists in answering this question.* *Optional*

Partnerships

Have you ever **advised** an owner-managed business to form an ordinary partnership?

- ○ Yes
- ○ No

To what extent do you agree that the following are advantages of forming/operating as an ordinary partnership for owner-managed businesses?

	Strongly agree	Agree	Disagree	Strongly disagree	Don't know
Ease of set up	○	○	○	○	○
Ease of dissolution	○	○	○	○	○
Flexible business structure	○	○	○	○	○
Privacy	○	○	○	○	○
Degree of personal control	○	○	○	○	○
Low compliance/administration costs	○	○	○	○	○
Tax treatment	○	○	○	○	○

Please specify any other important advantages (if applicable).

To what extent do you agree that the following are disadvantages of forming/operating as an ordinary partnership for owner-managed businesses?

	Strongly agree	Agree	Disagree	Strongly disagree	Don't know
Difficult/expensive to draft a comprehensive partnership agreement	○	○	○	○	○
Lack of limited liability	○	○	○	○	○
Lack of prestige/credibility	○	○	○	○	○
Lack of separate and continuing legal personality	○	○	○	○	○
Can be tax inefficient compared to company	○	○	○	○	○

Please specify any other significant disadvantages (if applicable).

Partnerships

Which of the following types of owner-managed business have you **advised** to form an ordinary partnership? Please tick all that apply.

- [ ] Agricultural
- [ ] Construction
- [ ] Manufacturing
- [ ] Wholesale and retail trades
- [ ] Motor vehicles and motorcycle repairs
- [ ] Accommodation and food service activities
- [ ] Transport (including taxis)
- [ ] Medical
- [ ] Other health, educational and social services
- [ ] Professional, financial and technical services
- [ ] Information, communication and technology
- [ ] Real estate activities
- [ ] Other

If you selected Other, please specify:

Have you ever **assisted an existing partnership with incorporation** into either of the following forms? *Please tick all that apply.*

- [ ] Company
- [ ] LLP

Have you ever **drafted a partnership agreement** on behalf of your owner-managed business client(s)?

- ○ Yes
- ○ No

How much would you typically charge an owner-managed business to draft a partnership agreement? *You may provide a range if it assists in answering this question.* *Optional*

LLPs

Have you ever **advised** an owner-managed business to form an LLP?

- ○ Yes
- ○ No

To what extent do you agree that the following are advantages of forming/operating as an LLP for owner-managed businesses?

	Very important	Quite important	Not important	Don't know
Flexible business structure	○	○	○	○
Ease of partner movement (in and out)	○	○	○	○
Limited liability	○	○	○	○
Separate and continuing legal personality	○	○	○	○
Privacy	○	○	○	○
Degree of personal control	○	○	○	○
Ability to satisfy customer/industry requirements	○	○	○	○
Tax treatment	○	○	○	○

Please specify any other important advantages (if applicable).

To what extent do you agree that the following are disadvantages of forming/operating as

an LLP for owner-managed businesses?

	Strongly agree	Agree	Disagree	Strongly disagree	Don't know
Expensive and complicated to set up	○	○	○	○	○
Costly administrative/compliance burdens	○	○	○	○	○
Lack of prestige/credibility	○	○	○	○	○
Lack of knowledge/information about LLPs	○	○	○	○	○
Can be tax inefficient compared to a company	○	○	○	○	○

Please specify any other significant disadvantages (if applicable).

LLPs

Which of the following types of owner-managed business have you advised to form an LLP? *Please tick all that apply.*

- [ ] Agricultural
- [ ] Construction
- [ ] Manufacturing
- [ ] Wholesale and retail trades
- [ ] Motor vehicles and motorcycle repairs
- [ ] Accommodation and food service activities
- [ ] Transport (including taxis)
- [ ] Medical
- [ ] Other health, educational and social services
- [ ] Professional, financial and technical services
- [ ] Information, communication and technology
- [ ] Real estate activities
- [ ] Other

If you selected Other, please specify:

Have you ever **formed** an LLP on behalf of your owner-managed business client(s)?

- ( ) Yes
- ( ) No

If yes, what difficulties (if any) did you encounter?

How much would you typically charge an owner-managed business for the formation of an LLP? *You may provide a range if it assists in answering this question.* *Optional*

Disincorporation

Have you ever **assisted** an owner-managed business with disincorporation?

- ○ Yes
- ○ No

To what extent do you agree that the following are barriers to disincorporation?

	Strongly agree	Agree	Disagree	Strongly disagree	Don't know
Administrative costs	○	○	○	○	○
Need to amend/settle agreements with third parties	○	○	○	○	○
Tax payable by the company	○	○	○	○	○
Tax payable by the shareholders	○	○	○	○	○

Please specify any other significant barriers to disincorporation (if applicable).

Has the withdrawal of disincorporation relief made you less likely to recommend disincorporation to an owner-managed business?

- ☐ Yes
- ☐ No
- ☐ Don't know

Conclusion

Finally, where did you hear about this survey?

- ○ Directly Contacted
- ○ Online Survey Advert
- ○ Chartered Institute of Taxation
- ○ Other

You have now reached the end of the survey. If you are happy to be contacted for a **further interview**, please leave your preferred contact details below. *This is entirely voluntary.*

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Final page

Thank you very much for your time in completing this survey.

If you have any questions, please do not hesitate to contact me at sophie.millington@chch.ox.ac.uk

ANNEX D: FOLLOW-UP SURVEY

Advising Owner-Managed Businesses in Relation to Form - Short Follow Up Survey

Page 1: Advising Owner-Managed Businesses in Relation to Form - Short Follow Up Survey

Advising Owner-Managed Businesses in Relation to Form - Follow Up Questionnaire

General Information

You have been invited to participate in this questionnaire following your response to my earlier survey titled 'Advising Owner-Managed Businesses in Relation to Form'. Please read through these terms before participating. You may ask any questions before taking part by contacting the researcher (details below).

This questionnaire is comprised of 4 short questions, and should take no longer than 2-3 minutes to complete.

Do I have to take part?

Please note that your participation is voluntary. You may withdraw at any point during the questionnaire for any reason, before submitting your answers, by closing the browser.

How will your data be used?

Survey responses will be anonymous and I will use all reasonable endeavours to keep them confidential. All respondents will remain anonymous in published data.

Your data will be stored in encrypted files and may be used in academic publications. Your IP address will not be stored. All questions are optional. Research data will be stored for a minimum of three years after publication or public release.

Who will have access to your data?

JISC Online Surveys and the University of Oxford are the data controllers with respect to your personal data and, as such, will determine how your personal data is used. Please see JISC's privacy notice here: https://www.jisc.ac.uk/website/privacy-notice. JISC Online Surveys will only share anonymised data with the University of Oxford, for the purposes of research.

Further information about your rights with respect to your personal data is available from https://compliance.web.ox.ac.uk/individual-rights.

I would like your permission to use your anonymised data from this survey in future studies, and to share data with other researchers (e.g. in online databases). Any personal information that could identify you will be removed or changed before files are shared with other researchers or results are made public.

Responsible members of the University of Oxford and funders may be given access to data for monitoring and/or audit of the study to ensure we are complying with guidelines, or as otherwise required by law.

This questionnaire is for a DPhil project. The principal researcher is Sophie Millington who is attached to the Faculty of Law at the University of Oxford. This project is being completed under the supervision of Professor Edwin Simpson.

This project has been reviewed by, and received ethics clearance through, the University of Oxford Central University Research Ethics Committee [Reference number: R65701/RE001].

What if there is a problem?

If you have a concern or questions about any aspect of this project, please speak to the researcher Sophie Millington (sophie.millington@chch.ox.ac.uk) or their principal supervisor Mr Edwin Simpson (edwin.simpson@chch.ox.ac.uk), who will do their best to answer your query. We should acknowledge your concern within 10 working days and give you an indication of how we intend to deal with it. If you remain unhappy or wish to make a formal complaint, please contact the Chair of the relevant Research Ethics Committee at the University of Oxford:

Chair, Social Sciences & Humanities Inter-Divisional Research Ethics Committee;

Email: ethics@socsci.ox.ac.uk;

Address: Research Services, University of Oxford, Wellington Square, Oxford OX1 2JD

The Chair will seek to resolve the matter in a reasonably expeditious manner.

Please note that you may only participate in this survey if you are 18 years of age or over.
If you have read the information above and agree to participate with the understanding that the data (including any personal data) you submit will be processed accordingly, please click to the next page to get started.

Page 2: Follow Up Questions

1. At the time of completing my initial survey (2020), through which business form did your accountancy firm operate? *Optional*

- Company
- LLP
- Partnership
- Sole trader

2. How has your personal experience of the above business form affected the likelihood that you would recommend its use by an owner-managed business?

- More likely to recommend to an owner-managed business
- Less likely to recommend to an owner-managed business
- No affect upon my advisory process
- Don't know

3. Do you recall noticing a mismatch (in the original survey) between the questions relating to advantages and disadvantages associated with LLPs? Note: the advantage options are expressed in terms of importance, and the disadvantages in terms of levels of agreeement - please see image attached to email for further information.

- Yes
- No
- Don't know

4. To what extent do you agree that the following are advantages of forming/operating

as an LLP for owner-managed businesses?

	Strongly agree	Agree	Disagree	Strongly disagree	Don't know
Flexible business structure	○	○	○	○	○
Ease of partner movement (in and out)	○	○	○	○	○
Limited liability	○	○	○	○	○
Separate and continuing legal personality	○	○	○	○	○
Privacy	○	○	○	○	○
Degree of personal control	○	○	○	○	○
Ability to satisfy customer/industry requirements	○	○	○	○	○
Tax treatment	○	○	○	○	○

Page 3: Final Page

Thank you for taking more time to answer my follow-up questionnaire. Your contribution is invaluable for the progression of my research. Please feel free to contact me if you have any further questions (sophie.millington@chch.ox.ac.uk).

ANNEX E: A POSTCRIPT ON DECOUPLING IN THE UK

E1. INTRODUCTION

Decoupling refers to the process of separating tax treatment from business form, which is typically achieved by way of explicit election.[1093] Traditionally, but not uniquely, the UK has chosen to tax corporate forms at the 'entity level' and noncorporate forms on a 'look-through' (transparent) basis, though this mould has been broken by the LLP. In any event, in no case is taxation treatment (entity vs aggregate) - separate from the selection of business form - a matter of choice for taxpayers in the UK. As such, the business owner's choice in relation to the taxation of business activity is best described as *implicit* i.e. the desired tax treatment is obtained by structuring one's affairs in a particular way, *designed* to attract the application of a particular tax regime. This is exactly what occurs when a would-be partner adopts the company as a business form to access preferential tax rates, thereby raising the concerns addressed in Chapter 4.

E2. IS DECOUPLING DESIRABLE?[1094]

In pursuit of business form neutrality, one might consider the merits of introducing an *explicit* election, enabling business owners to *choose* whether the business activity is taxed on an entity or transparent basis, irrespective of the form selected as the suitable medium. 'Explicit

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1093 Elections are a familiar feature of tax design, and common to many systems, including the UK. For example, Chapter 4 discussed the 'cash basis' election available to unincorporated businesses.

1094 Admittedly, this debate could form the basis of an entire independent thesis, so the discussion herein is broadly introductory, and simply designed to provoke further thought on the matter. Space constraints preclude anything more detailed on this point. Decoupling is a separate consideration from arguments pertaining to the introduction of a new business form, which could have flexible tax treatment attached to it; the latter is beyond the scope of this thesis.

elections, by definition, affect taxes only; they lack non-tax legal impact…'[1095] and could, consequently, operate as saviour of the ordinary partnership (and perhaps encourage sole-trader activity depending on the scope of the election). To some extent, this type of election exists in various forms across many jurisdictions, the most [in]famous of which is the US LLC and associated 'check-the-box' system.[1096] Albeit common in recent years, this type of reform is controversial.[1097] The OTS has previously considered the possibility of taxing companies on a look-through basis:[1098]

> [o]f all the topics covered during this [small company taxation] review, none were more divisive than look through. Respondents were either strongly against or strongly in favour; with accountants and tax advisers generally against, small company owners generally in favour and representative groups and bodies split between the two camps.

That being said, there was one area of consensus; '[o]ne area where virtually all respondents were in agreement is that if any look-through scheme was introduced, it should not be compulsory.'[1099] The objections to explicit elections proceed along similar lines; 'they

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1095 Heather Field, 'Choosing Tax Explicit Elections as an Element of Design in the Federal Income Tax System' 47 Harvard Journal on Legislation, 21 (2010), 30.

1096 US Treasury Regulation 301.7701-3. The OTS Small Company Taxation Review (n 40) Annex C discusses other analogous international business models such as the French *Enterprise Unipersonelle à Responsibilité Limitée* ("**EURL**") and New Zealand's Look Through Company ("**LTC**").

Against a background of higher effective tax rates being imposed on corporate entities drawing down profits, Ribstein (n 146) 122 opined that the 'big impediment to change all along was federal tax law... [f]ims and their lawyers had to work within the tax classification framework and weaken it from within'. See also Michael Knoll, 'Tax Planning, Effective Marginal Tax Rates, and the Structure of Income Tax, 54 Taxation Law Review, 555 (2001); David Schizer, 'Frictions as a Constraint on Tax Planning', 101 Columbia Law Review, 1312 (2001).

1097 See, for example, George Yin, 'The Taxation of Private Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations, SMU Law Review, 125.

1098 OTS Small Company Taxation Review (n 40) 15.

1099 OTS Small Company Taxation Review (n 40) 15. The author agrees in respect of explicit elections in this area generally.

generally criticise tax elections as complex, costly, revenue-reducing, and inequitable.'[1100] Expressed in the abstract, they reflect legitimate concerns as a matter of tax design policy. Yet it is important to consider their specific application in the context of the proposal for an elective business-form tax regime in the UK, since 'explicit tax elections, in limited circumstances and when properly designed, can be employed to accomplish valuable policy goals.'[1101]

E2.1 Complexity and Cost

From a complexity and cost-based perspective, the availability of elections forces a taxpayer (personally or through an adviser – the latter generating expenditure) to consider their own eligibility for the election and, if eligible, thereby consider the merits of the opportunity to make an election. The analytical stage of the process will be more difficult if there is uncertainty as to the taxpayer's business position in the future[1102] (as is often the case with owner-managed entities). Furthermore, the administrative election process itself may present an obstacle if not easily comprehensible. In turn, complexity generates a risk of errors,[1103] which is mirrored by costs imposed upon the revenue collection authority (here HMRC).[1104] Nonetheless, it is clear that owner-managed businesses today already dedicate a significant amount of resources to tax planning activity. Complexity and cost may be reduced by the introduction of an explicit election since they have less distortionary effects than implicit tax planning opportunities that exist in a discontinuous tax system; this reduces deadweight

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1100 Field (n 1095) 21.

1101 Field (n 1095) 25.

1102 Field (n 1095) 27. See also Leslie Loffman and Sandford Presant, 'Choice of Entity – Business and Tax Considerations', 799 Practising Law Institute, Tenth Annual Real Estate Tax Forum, 307 (2008).

1103 See Victoria Levin, 'The Substantial Compliance Doctrine in Tax Law: Equity vs Efficiency', 40 UCLA Law Review, 1587 (1993).

1104 Field (n 1095) 29.

economic loss.[1105] The complexity of the election process itself is a simple design problem and there is no reason why this could not take the form of a 'check-the-box' on the tax return, as is the case with the cash basis election.[1106] Indeed, the introduction of the system may give credence to the retention of a separate partnership tax return.[1107]

E2.2 Equity

Turning to equity-based considerations, the introduction of an explicit election is beneficial to the extent that it can facilitate the equal taxation treatment of economically similar activities conducted via different business forms. It is important to appreciate that true and complete equity demands that the election ought to be available to all business structures i.e. sole traders and partners may be taxed as corporations, and corporations may opt for look-through taxation. To do otherwise would create further distortions in the tax system, which is what the election is designed to remedy.[1108] Admittedly, this will raise some interesting, and difficult, design questions. On the partnership level, it makes sense to require the election to be made jointly, reflecting the nature of the enterprise itself (that is not to say the matter will be uncontentious). More challenging is the matter of how to deal with unincorporated forms electing to be taxed on the entity basis. A mechanism would be necessary to determine whether profits are treated

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1105 Field (n 1095) 30, 37: '[e]xplicit elections enable taxpayers to focus on the non-tax business and legal consequences, rather than the tax ones…[t]his can enhance efficiency by relieving taxpayers of the need both to waste resources to restructure a desired transaction and to use a transaction structure that is suboptimal from a business perspective in order to obtain a particular tax treatment.'

1106 There is also no good reason to limit reforms to businesses based on size. The introduction of additional boundaries in this already complex arena is undesirable.

1107 Considered in the OTS Partnerships Review (n 164) 39.

1108 Field (n 1095) 43 warns about the risk of creating further problems in this context. As discussed therein, this could be addressed by introducing a mandatory form of alternative tax treatment where certain conditions are met (which would presumably be designed with a view to discouraging owner-managers from incorporating). A reform of this kind would necessarily introduce further boundaries into the tax system; this must be regarded as undesirable in a regime that is already plagued by boundary problems. See Adam and Miller (n 4) 10.

as drawn-down or retained by the taxpayer(s). The entity system fits most naturally with forms possessing legal personality, and with that in mind it makes sense that countries with elective tax treatment, such as the USA,[1109] have chosen to attach explicit elections to corporate forms with asset-partitioning features. Televantos has rightly observed that the partnership does exhibit some asset-partitioning features, albeit less so than the company.[1110] Furthermore, taxation law does, and has had to, grapple with the separation of the partners from the partnership in relation to matters such as the apportioning of expenses.[1111] Accordingly, the issues are likely to be surmountable. The real problem likely lies with the sole trader; as the business is conducted on an individual basis the critical asset partitioning features are inherently absent.

It is also fair to say that equity in the sense of availability of the election may not work in practice for those unaware and lacking the resources to seek professional advice.[1112] Once again, publicity in clear and accessible terms is key.

One matter that cannot be ignored is that if the election is introduced without further systemic changes, the gulf in treatment between business owner-managers and employees will widen, which is not ideal.[1113] There are two sensible ways of responding to the issue. The first is to say that introduction of the explicit election should proceed because it will serve as an impetus to adopt other desirable taxation reforms, closing the discontinuity of treatment (along

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1109 See also OTS Small Company Taxation Review (n 40) Annex C.

1110 Televantos (n 47).

1111 ITTOIA 2005, s 34; See Ray (n 898) Chapter 3.

1112 David Rosenbloom, 'Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt', 26 Sydney Law Review, 17 (2004) 23-26.

1113 See *inter alia*, Cribb, Miller and Pope (n 4); Adam and Miller (n 4); Adam and Miller (n 664).

the lines proposed by Adam and Miller).[1114] The alternative is to introduce the election alongside wider systemic reform, in pursuit of a fully equitable tax system.

E2.3 Revenue Implications

Undoubtedly (based on current rates) the introduction of an explicit election would result in a further reduction in tax revenue. The taxpayer will utilise the tax planning opportunity to maximise their own welfare. Of those partnerships in existence, profit-making enterprises would rationally adopt the corporate taxation regime. Likewise with the sole trader if the election were extended to them. This is a reasonable concern but is part of the trade-off in pursuit of neutrality; the question is simply one of priority. In any event, the revenue effect could be mitigated by the introduction of a broad range of reforms.

E3. CONCLUSION

Whilst some legitimate concerns about the introduction of an explicit election in this area exist, a properly designed election should receive further consideration as being in the interests of business form neutrality, equity, and arguably the reduction of taxpayer administrative costs. In effect, it would simply replace a choice implicit in today's tax system, which could improve the utilisation of unincorporated forms where they are commercially suitable enterprises. No doubt it would help to neutralise the present effects of the tax system on the selection of business form; this must be regarded as desirable as a matter of policy.

[1114] (n 4).

The election would need to be properly advertised (as with the disincorporation relief proposed in Chapter 5) and introduced in a simple form, perhaps by way of a 'check-the-box' approach. Difficult design choices would need to be made, but arguably this is less onerous than complete systemic reform.[1115] In any event, it is not necessarily a replacement for more extensive reform which serves to remedy discontinuities in taxation. In many respects, it is complimentary, and could be a valuable tool in alleviating the tax burden currently borne by owner-managed businesses that pursue growth and investment that, for sound commercial reasons, prefer to operate via an unincorporated form.[1116]

By no means is the author suggesting that this is an easy path forward, but simply one deserving of further attention. The invitation for debate is extended accordingly.

[1115] Field (n 1095) 42.

[1116] Since only corporation tax is levied on retained profits (there are no further personal tax implications, or NICs to be made).

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