

What contractors need to know about investing through their contractor Ltd company

Contractors enjoying a stream of lucrative contracts can easily find large cash balances building up in their [contractor limited company](#) bank account. They may be tempted to leave these funds on long-term high interest deposits, or to invest them in shares or bonds.

According to James Abbott of contractor accountant [Baker Watkin](#), although all contractors should save cash for a rainy day, hoarding too much surplus cash and using it to invest could actually increase their tax bills.

"With the low interest rates currently available on current account deposits, some contractors have looked elsewhere for places to invest the cash in their limited company, because they don't want to pay the income tax involved in transferring cash out of their companies and to themselves," explains Abbott.

"The contractor could borrow the money from their company as a [directors loan](#) but this can create Section 419 and Benefit in Kind tax charges," he continues, "so the contractor invests company cash, and this leads to all sorts of complications."

Releasing cash on closing down - Entrepreneurs' Relief and ESC C16

Under certain circumstances, contractors can tax efficiently release retained funds in their contractor limited company via HMRC approved schemes, such as [ESC C16](#) and [Entrepreneurs Relief](#).

According to Abbott, Entrepreneurs' Relief was designed to reward risk-taking businesspeople who had built up a business and wanted to sell-up, but contractor limited companies also qualify when they are being closed down.

"A contractor's accountant can apply to [HMRC](#) for [ESC C16](#) and can combine this with a claim for [Entrepreneurs' Relief \(ER\)](#) and," he says, "unless the contractor's company has a "significant" amount of investment activity, then ER at 10% is paid on the funds released from the company."

Compare this to an ESC C16 claim without ER, the rate increases to 18%. A claim for ER could not be made if there was 'significant' investment activity. However, what is significant is not defined by statute, although HMRC say they will look at whether a company's non-trading activities amount to more than 20% of income, assets, expenses or time taken by employees.

For example, say a contractor limited company ABC Ltd has £20,000 of consulting income in a year and the only assets are unit trusts worth £50,000, assumed not to be required for trading purposes, which provide an income of £7,000 in the same year.

"HMRC could well challenge this scenario if the contractor wanted to claim ER", warns Abbott. "HMRC could argue that the non-trading income is greater than 20% of the total income, which might indicate that ABC Ltd is non-trading and deny a claim for ER. They may also highlight that all the assets are non-trading assets, well over the 20% threshold."

Contractors risk becoming a non-trading Close Investment Company (CIC)

"Personal income tax rates are normally higher than corporation tax for companies and the prospect of re-investing limited company profits into investments at a much lower rate is naturally attractive to contractors," continues Abbott. "That is why a contractor limited company classed by HMRC as an investment business attracts a higher rate of corporation tax under the Close Investment Company (CIC) rules."

A CIC pays corporation tax at 28%, rather than the 21% small company rate generally enjoyed by contractor limited companies. This could happen to a contractor's company in extreme cases if the company's activities are no longer wholly or mainly commercial activities.

However, a contractor limited company that makes significant investments in land and estates let to third party tenants escapes the CIC rules but would still be taken into account when assessing whether the contractor was entitled to claim ER, although Abbott urges contractors entering the property sector to seek professional advice on company structures.

Retaining cash for trading purposes

Genuinely retaining some funds in the business for trading purposes such as [VAT](#), corporation tax, working capital or earmarked for expansion will always be acceptable to HMRC as it is prudent financial management.

The key point, according to Abbott, is that contractors must consider and document the reasons for

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James Abbott, Baker Watkin

holding those funds for trading purposes and be clear that the kind of investment is consistent with the intended use of the funds.

"There's no point having a board minute saying the £100,000 sat in a high earning long-term bond is for short-term financing if six month's notice is required to draw down funds," he explains. "Businesses are rewarded for taking risk, and ultimately creating jobs and value, through lower taxes. Businesses that choose not to take those risks, and opt for safer investments, lose that benefit."

Contractors and inheritance tax



Contractors concerned about inheritance tax changes (IHT) on their estate willed to family should also be aware that if their company or some of its assets were deemed to be non-trading, then IHT would apply on the non-trading element.

As Abbott explains, the trading assets of a business are often relieved from IHT under Business Property Relief because HMRC does not want to put out of business a potentially sound company, which is generating jobs and tax revenue, by crippling beneficiaries with IHT charges. "But hiding non-trading assets in a trading company in the hope they will escape IHT just won't work," he cautions. "Contractors need to ensure that they document that there are trading reasons for holding large cash deposits and investments in their trading company."

Abbott urges contractors to be realistic about what is possible: "Contractors should discuss options with their accountant or Independent Financial Adviser, and may find that in many circumstances the advice is to make larger scale investments outside the company even if it involves taking the personal tax hit and invest in ISAs and similar investments." He concludes: "Company pension schemes can also be a tax advantaged investment for contractors with contractor limited companies."

Published: Wednesday, March 10, 2010

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James Abbott heads up Baker Watkin's tax department and often speaks on freelancer / contractor tax matters. He has his own portfolio of contractor clients.

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