

Closing a contractor limited company tax efficiently using ESC C16

Contractors may want to [shut down their contractor limited company](#), or dissolve it, and pay themselves any leftover cash. They might be planning to take a long break from their contracting career, are retiring or just taking up a permanent role. The way the company is closed can have a big impact on the amount of cash left over for the contractor.

According to James Abbott of contractor accountant [Baker Watkin](#), rather than take any cash out of the company as income, thus potentially attracting higher rates of tax, contractors can apply to [HMRC](#) to take the final payment as a capital distribution. This is done using [Extra Statutory Concession C16](#), better known as [ESC C16](#).

Abbott explains: "By distributing the cash from the dissolving business as capital rather than income the contractor will be charged Capital Gains Tax (CGT) on the payment. The rate of CGT will be between 10% and 18% whereas income tax could be as high as 25% of the net dividend received. With the increased income tax rates after 6 April 2010 the gap can only widen.

Furthermore, each individual may make capital gains of £10,100 (2009/10) each year before they pay capital gains tax. That means this is a particularly useful strategy if the contractor has already used up all their basic rate income tax allowances."

Dissolving a limited company - using professionals or DIY?

But how to go about it? Abbott says that contractors can choose to pay an insolvency practitioner or liquidator to liquidate the business. "Any distributions from their company after the liquidator is appointed would be treated under capital gains tax rules without asking permission from HMRC," he says. "However, a liquidator will potentially cost the contractor thousands of pounds in fees."

Often a more cost effective solution is for the contractor to ask HMRC to apply ESC C16 and then apply to [Companies House](#) to have their limited company struck off the register. Although contractors can manage the process themselves, Abbott suggests contractors get help from their accountant: "Striking off a company is straightforward, but HMRC's conditions for qualifying for ESC C16 are strict and contractors who are judged to be flouting the rules will generate unwelcome attention or may even fail to qualify at all."

If HMRC approves the application for ESC C16, then the contractor is required to distribute all the assets, including any cash left in the company's bank account, to the shareholders and ensure the limited company is struck off from the register at Companies House.

ESC C16 - how does it work?

When making the application to HMRC, the contractor has to make a number of other assurances, which include:

- o That the contractor's limited company is not being investigated
- o The contractor does not intend to trade or carry on business in the future
- o The company intends to collect its debts, pay off its creditors and distribute any balance of assets to its shareholders (or has already done so)
- o That the contractor confirms that they will pay any outstanding corporation tax plus the capital gains tax which arises from the dissolution.

If ESC C16 applies, then the normal rate of CGT will be 18% potentially, reduced to 10% with Entrepreneurs Relief. Most contractors will qualify for the 10% rate if, for at least the 12 months immediately prior to the company funds being distributed, they:

- o are an employee or officer, including director, of the company
- o have at least a 5% shareholding
- o have at least 5% of the voting rights.

In his opinion, Abbott explains that it is important that the limited company must be seen by the taxman to have a 'clean' record. "HMRC will certainly do their homework," he says. "If they find out the contractor has a history of late payments, errors in returns or that they have used offshore solutions to avoid paying tax, then I believe they may well look at any application more closely. It might also be refused if the company has only been trading for a short time or it looks like it was created with the express purpose of avoiding tax as there is legislation HMRC can apply to cancel the tax advantage."

Should the application be refused, it is likely the contractor will have to bite the bullet and have the [dividend](#) treated under income tax rules rather than capital. If HMRC is likely to give the green light, however, it usually takes four to five weeks for the application to be granted.

“ Striking off a company is straightforward, but HMRC's conditions for qualifying for ESC C16 are strict ”

James Abbott, Baker Watkin

Fair play from HMRC

Abbott says HMRC is typically quite reasonable with ESC C16s and will take into account extenuating circumstances. "I've had contractor clients closing their limited company after being offered a dream permanent job, but twelve months later start contracting again with a new limited company because they were made redundant. HMRC makes allowances for circumstances like these, if it is clear that the intention is genuine, the original company was struck off and the contractor is not trying to avoid paying tax then I would expect HMRC not to withdraw permission to use ESC C16.

"It is also possible for a contractor to liquidate one limited company but keep another going if they significantly differ in type," he continues. "If, say, a contractor had one limited company for software development and another selling rare stamps, HMRC is likely to allow one of the companies to be dissolved using an ESC C16 if that trade has genuinely finished and there was no tax avoidance intention."

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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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