Contractor Doctor: Can Entrepreneur's Relief help extract cash from my ltd company?

Dear Contractor Doctor,

I am an IT contractor and I run a contractor limited company with my husband, who is an engineering contractor, we each own a 50% share in the company. We can live well on half of what we earn, with each of us taking minimum salaries and dividends up to around £45,000 per year. That leaves around £100,000 per year in retained profits, which we are keeping in cash.

We have already accumulated a significant cash pile and plan to continue building our cash in the company for as long as we can, maybe for as long as another 10 years.

Can we then simply close our contractor limited company and extract our cash tax efficiently using Entrepreneur's Relief, only paying Capital Gains Tax at 10%?

Thanks

June

Contractor Doctor says:

The answer in nearly all cases will be no because of the amount, says **James Abbott**, owner and head of tax at contractor accountant **Abbott Moore LLP**. He explains that a contractor saving up significant amounts of cash in their **contractor limited company** in the belief that they can close the company and extract the cash at lower rates of Capital Gains Tax will always experience two major hurdles:

Either the Corporation Tax (CT) rate will go up because the contractor limited company becomes a close investment company (CIC); and/or

The rate of Capital Gains Tax (CGT) will increase because the contractor limited company will not qualify for Entrepreneur's Relief (ER).

"There's no law against a contractor, or any business person for that matter, retaining large sums of cash in their business," says Abbott. "But if the amount held is beyond what HMRC deems reasonable for trading purposes, then they may not agree to apply ER at 10% on the release of cash as capital when the company is closed."

Break the 20% rule and lose Entrepreneur's Relief

Abbott uses June and her husband as an example: "As a husband and wife contractor limited company, they are starting to build a substantial amount of cash in their contracting business bank account. This starts endangering their trading company status. One of the tests of being a trading company is that less than 20% of its assets are non-trading assets. Therefore, when large sums of cash held for non-trading purposes start to build up, tipping the company over that 20% limit, the contractor risks HMRC considering the company to be non-trading."

Abbott continues: "Even if all the assets are in cash, you would still have to justify to a tax inspector that the assets are held for trading purposes. For the average contractor, with very large cash balances, that is going to be difficult."

The result, says Abbott, is that the contractor limited company would almost certainly lose any chance of qualifying for the lower ER rate of CGT of 10%. "In practice, what would happen is the contractor would prepare their personal tax return after closing their company and make a decision about whether their company was a trading company and make a claim for ER or pay 18% CGT. HMRC may choose to enquire into the contractor's personal tax return and if a claim for ER had been made incorrectly they would refuse the claim."

The longer a contractor leaves the situation, the larger the amount of cash, income generated and time involved in managing the money, the less likely they are to be believed by HMRC and the tougher it becomes to convince the taxman that such large assets are held for trading purposes, warns Abbott.

Become a CIC and lose ER

A contractor limited company becomes a close investment company (CIC) when its income from investments exceeds its income from trading – the contractor's fee income earned from working for clients.

"As soon as the income from investments, even if they are in cash, exceeds trading income, the contractor limited company becomes a CIC and no longer a trading company," continues Abbott. "From that year onwards, corporation tax (CT) on all the contractor limited company's activities increases from 21% to 28%. So, on closing the company, the contractor's limited company will not qualify for ER, as only trading companies receive this benefit. So CGT will be at the 18% rate under **Section 1030A**."

Abbott illustrates the options with examples that show that if a contractors' corporation tax rate increases to 28%, they may even be worse off leaving money in the company, particularly if they can keep their personal income below the £100,000 limit:

If a contractor saves money rather than pays dividends at higher rate tax, then the company may become a CIC, attracting CT at 28%. Therefore, for every £100 earned by the company, £28 will be paid in higher rate CT. When the contractor closes the company using **Section 1030A**, because it is a CIC it cannot qualify for ER and a further £12-96 is paid, resulting in the contractor retaining £59-04 out of every £100 (£100-£28-£12-96 = £59-04).

If the contractor does not build a large cash pile, does not fail the 20% or CIC rules and pays dividends at the higher rate, then for every £100 in the company, £21 is paid out in CT (£100-£21 = £79), 25% is paid as a higher rate dividend, resulting in the contractor retaining £59-25 out of every £100 (£100-£21-£19-75 = £59-25).

> **"The tax regime in the UK typically places a greater burden of tax over time. So, if contractors spot a tax-efficient investment opportunity that gives them a yield that fits their risk profile, they are generally better off taking advantage of that opportunity now."**
>
> James Abbott, Abbott Moore LLP

Although it may not ultimately be the most tax efficient method of taking cash out of a contractor limited company, it would be possible for June and her spouse to cease trading, accept CIC status and run the company as a CIC, and withdraw minimum salaries and a basic dividend until the cash in the company is exhausted.

Retaining cash could be an 'opportunity cost'

However, Abbot continues, not only are most contractors not any financially better off by stashing the cash in their company over the long term, but they may be losing out on investment opportunities, as Abbott explains.

"The tax regime in the UK typically places a greater burden of tax over time. So, if contractors spot a tax-efficient investment opportunity that gives them a yield that fits their risk profile, they are generally better off taking advantage of that opportunity now. The alternative means waiting for an uncertain future or possible tax benefits ten years down the line."

James Abbott

Owner

Abbott Moore LLP

James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. **Read Full Profile...**

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Abbott concludes by urging contractors like June and her husband to talk to their independent financial advisers as well as their tax advisers, to explore other tax-efficient options open to them, such as **pensions** and ISAs.

Good luck with your contracting!

Contractor Doctor

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