Contractor guide to Section 1030A distributions (ESC C16) closing a limited company

Contractors with cash balances in their limited companies can tax efficiently extract cash reserves of up to £25,000 as capital using Section 1030A distribution on striking off the company.

"The government has made the former Extra Statutory Concession (ESC) C16 a statutory instrument, now known as Corporation Tax Act 2010 sections 1030A and 1030B," explains James Abbott, owner and head of tax at contractor accountant Abbott Moore LLP.

"This now makes it easier for a contractor to distribute surplus cash when closing their company. "However, there is a sting in the tail in the form of a £25,000 limit on funds that can be distributed as capital. This means that some contractors may find it more tax efficient to distribute cash as a dividend, or even appoint to a formal liquidator."

When a Section 1030A distribution can apply

Under the old ESC C16 rules, contractors would write to HMRC explaining that they no longer intended to trade as a contractor through their limited company. They would ask that they could distribute all the funds held by the business as capital, thus qualifying for lower capital gains tax, rather than income tax on dividends.

Now, according to Abbott, to qualify under Section 1030A, contractors must:

Have applied to Companies House to strike off the company or have the intention of doing so. Companies House commencing striking off proceedings under section 1000 of the Companies Act 2006 would also qualify

Have secured, or intend to secure, any outstanding fees owed to the company by clients

Have paid, or intend to pay, any company debts and liabilities

Have £25,000 or less in funds to be distributed – this limit is per company and not per shareholder.

"The £25,000 cap is a 'cliff edge' limit. That means if a contractor exceeds the limit even by only a single pound, then none of the funds held in the company can be distributed as capital," says Abbott.

Initiating a section 1030A distribution

"Contractors traditionally applied ESC C16 and closed their contracting business because of retirement or securing long-term permanent employment. "The reasons for initiating a section 1030A distribution will be much the same."

Contractors no longer have to write to HMRC to initiate the process, but Abbott urges contractors to involve their accountant right from the start, as there are potentially costly complications. There are three ways of starting the process:

The contractor has applied to Companies House to have the company struck off

The contractor has the intention of ceasing trading and starting the section 1030A process

Companies House has started proceedings against the contractor limited company because it has failed to submit accounts or deliver an annual return.

HMRC can choose to investigate a contractor's company at any time during the striking-off process, and can even halt the process if they suspect irregularities. This is why professional assistance from an accountant could mean the difference between a smooth and successful section 1030A distribution, and a messy expensive HMRC investigation.

The timing of the distribution is crucial until HMRC issues guidance

HMRC has yet to issue guidance on how section 1030 will be applied in practice, so Abbott suggests contractors time the distribution carefully.

"A contractor could cease to trade and initiate the section 1030A process with more than £25,000 in the company to distribute, fully intending to declare a dividend to take the funds below the limit. But because HMRC has not issued guidance, it could argue that the funds will not qualify because they are over the limit at the time the contractor intended to cease trading.

"So contractors should ensure that any dividends are declared before initiating the section 1030A process, and should tread carefully until such time as HMRC's view is established. A sensible approach might be for HMRC to consider a formal board minute noting the company's intention to seek striking off as the defining point."

When a section 1030A distribution may not be the most tax efficient route

Because of the £25,000 cap introduced when ESC C16 became a statutory instrument in March 2012, Abbott explains that some contractors may find simply declaring a dividend or formally liquidating the company may be more tax efficient than capital distribution.

“Contractors with small sums retained in the company and who are not higher rate taxpayers will find declaring a final dividend a more tax-efficient option. There is no Capital Gains Tax (CGT) on the first £10,600 and then it is charged at 10% on the remainder up to £25,000.

“If a final dividend is covered by a contractor’s basic rate tax allowance, then because dividends do not attract an income tax charge up to the higher rate threshold, it is more beneficial to declare a dividend than distribute funds as capital and apply CGT.”

When the cash reserves to distribute start reaching sums in excess of £50,000, then Abbott suggests contractors consider using a liquidator, which will result in all the funds being treated as capital, regardless of the £25,000 limit. The liquidator’s typical fees of £2,500 - £4,000 may be considerably less than the resulting income tax savings.

Section 1030A pitfalls

“Applying section 1030A can only be used by contractors genuinely ceasing to trade and not as a tax avoidance mechanism to repeatedly close and restart contracting businesses,” warns Abbott. “There is legislation to deal with that approach and HMRC has rules in place to prevent this.”

HMRC may withdraw favourable tax treatment within two years of making the distribution if:

The company has not been dissolved, or

The company has failed to secure, so far as reasonably practical, the payment of all sums due to the company or to satisfy all of its debts and liabilities.

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>
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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.

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Furthermore, a contractor can’t transfer trade into another company the contractor has shares in, because this is caught by transactions in securities legislation. This stops contractors running a limited company from shutting it down to get the 10% tax rate and then just carrying on with another company.

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