Tax efficient distribution of contractor funds using members' voluntary liquidation

Contractors retiring or taking a permanent role and who have cash in excess of £50,000 left in their contractor limited company can use a members' voluntary liquidation (MVL) to distribute the funds tax efficiently.

"Following the creation of Section 1030A, which replaced ESC C16 in April 2012, contractors with cash in excess of £25,000 left in their company were forced to distribute funds as income and not capital, thus incurring income tax liabilities at a marginal rate as high as 37.5%," explains James Abbott, owner and head of tax at contractor accountant Abbott Moore.

However, according to Andrew Rosler, a licensed insolvency practitioner and managing director of Ideal Corporate Solutions, contractors can choose to close their company using a members' voluntary liquidation. "Liquidating a contractor's company by a licensed insolvency practitioner enables high cash reserves to be distributed as capital, potentially attracting a tax rate as low as 10%," explains Rosler.

Consider exit strategies well in advance of company closure

Both Abbott and Rosler urge contractors to consider exit strategies from their contracting business well before the end of their company's life.

"There may be dividend strategies in the years preceding any business closure that may improve the contractor's finances," highlights Abbott. "This may include a deliberate dividend strategy to reduce the cash balance below the £25,000 threshold for a Section 1030a distribution.

"Alternatively, a contractor who knows their income will fall, possibly due to retirement, may choose to leave the cash in the company and take dividends up to their basic rate allowance over successive years."

But Abbott acknowledges that many contractors taking retirement or moving into a long-term permanent role are seeking both closure and peace of mind that any risks associated with the company, such as IR35 or claims from clients, are minimised.

Alternatively, they may have other financial reasons for needing use of the money more urgently, such as paying off mortgages or other personal debts. And, of course, many contractors will want to avoid the costs of running a contractor limited company that isn't trading.

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>
> Andrew Rosler, Ideal Corporate Solutions

Determining the point at which the cost of liquidation is less than the tax saving

As Rosler explains, contractors should consider the cost of a members' voluntary liquidation before pursing one: "The costs of liquidations have reduced significantly, and contractors can find licensed insolvency practitioners who will perform the liquidation at competitive fees. However, there is a threshold below which the liquidation option is not cost effective for the contractor."

Abbott agrees, and provides an example: "For a contractor about to retire and who has a £35,000 cash balance in their company, a logical option might be for them to go to a liquidator and get the tax benefits of a capital distribution, rather than pay 25% tax on an income distribution.

"But when you look at the numbers, it doesn't stack up. The contractor would pay £2,500 in income tax on the £10,000 above the section 1030a threshold. Distributing the £10,000 as capital at 10% tax saves the contractor £1,500."

Rosler takes up the story: "Even competitive insolvency practitioners will charge in the region of £2,500 plus expenses and VAT, which means in this scenario, the contractor would actually end up out of pocket."

Both experts agree that the threshold at which a members' voluntary liquidation is likely to make financial sense is approximately £50,000. However, contractors should run through the numbers with their accountant to determine their exact position, as there may be a middle ground where dividends can be taken in advance of going down the section 1030a route.

> **"There may be dividend strategies in the years preceding any business closure that may improve the contractor's finances"**
>
> James Abbott, Baker Watkin

Members' voluntary liquidations – how they work

"The insolvency practitioner would normally receive confirmation from the contractor's accountant that the appropriate tax advice has been delivered and that all the tax paperwork has been done," says Rosler. That would be things such as final VAT returns, cessation accounts and filing of final corporation tax returns."

Rosler maintains that ensuring that all the tax administration has been completed and that the majority of liabilities have been discharged is key to keeping 'pre-packaged' members' voluntary distributions cost effective. "With a pre-packaged liquidation for a contractor's company, ideally the insolvency practitioner will focus on the statutory process and distribution of cash," he adds.

The insolvency practitioner will help the contractor create a ‘declaration of insolvency’, which is the first step in the liquidation, as described in the Insolvency Act 1986.

“The declaration of insolvency demonstrates that the company will be able to settle or secure liabilities and the costs of liquidation within 12 months,” continues Rosler. “After the declaration, the company convenes a meeting of shareholders to put it into liquidation and appoint a licensed insolvency practitioner as the liquidator.”

In practice, it is likely that it is the contractor, or the contractor and their spouse, who are the directors and shareholders, so the shareholders’ meeting and resolution is a formality, but one that must be minuted.

“Once the liquidator is appointed, the directors’ powers cease and all control over the assets is passed to the liquidator,” says Rosler. “From that point on, the contractor usually does nothing until the cash arrives in their bank account.”

The liquidator will post notices in the London Gazette that the contractor’s limited company is undergoing a members’ voluntary liquidation, and inform Companies House that the company is being liquidated. Shareholders are also given 14 days notice that the company will be liquidated.

“Assuming all the paperwork is up-to-date and there are no liabilities, the members’ voluntary liquidation can take no more than 21 days from the appointment of the liquidator to the distribution of cash,” says Rosler. “If the shareholders waive their statutory notice period, the process can be completed even sooner.”

Directors’ loan accounts

Once the tax paperwork has been finalised and liabilities settled, but prior to the liquidation and distribution, contractors may require access to some of the funds. Rosler’s solution is to allow the contractor to draw down on their directors’ loan account.

“It may be that the contractor wants to take some cash out of the business but does not want to attract income tax on a salary or dividends. It is possible, in principle, to draw down short-term cash against a directors’ loan account and offset the loan against the capital distribution, with little or no additional tax liability to the company or individual.”

HMRC technically have to clear this process, but in Rosler’s experience there is rarely any objection

‘Dividends in specie’ – dealing with property

When the contractor’s company owns assets such as property, Rosler confirms that the liquidator can assign ownership to different shareholder beneficiaries of the distribution. This is known as distributing ‘dividends in specie’, and Abbott highlights that there can be stamp duty and land tax advantages to acquiring property assets via a liquidation.

However, Abbott also warns contractors that if the property has increased in value from its purchase price to value at liquidation, the company must pay capital gains tax on the of disposal the property to the contractor.

He explains: “If the company bought the property in the past for £50,000, and it is worth £100,000 at the time of liquidation, then the contractor’s limited company is liable for capital gains tax on the £50,000 capital appreciation, less an allowance for the increase in the Retail Prices Index.”

Entrepreneur’s relief

The main objective of using a member’s voluntary liquidation is to secure a lower capital gains tax rate on the cash distribution, rather than a higher income tax rate. Contractors who qualify for Entrepreneur’s Relief (ER) can benefit from a 10% marginal rate on distributions.

Abbott explains: “Large cash balances in a company are not a problem as long as they have arisen from trading and the contractor has not actively managed the cash by seeking a greater return.”

In order to qualify for ER, Abbott says that both the company and contractor must satisfy specific criteria:

The company must have been trading for 12 months up to the date that it ceases to trade

The contractor must be at least a 5% shareholder and employee; this can mean being a director or company secretary for the 12 months immediately preceding receiving any distribution from the company under ER.

Abbott also highlights that a spouse’s newly awarded shares don’t inherit the shareholding period from their spouse: “Say a contractor was a 100% shareholder for 18 months and then got married and decided it might be good idea for their spouse to receive some of the shares.

“The 12-month clock will start ticking when the spouse receives their shares. If the contractor then wins a dream permanent job and distributes the funds as a capital gain nine months later, the spouse won’t qualify for ER on their share of the distribution.”

Pitfalls – contingent liabilities

As Rosler explains, most pitfalls are where the insolvency practitioner has not been made aware of contingent liabilities, which may include bills arising from previous trading premises, overlooked utilities expenses, or even indemnities or warranties provided for past projects that may crystallise after the liquidation.

“For contractors operating through their own limited company, there is limited scope to incur liabilities and fewer grounds for contingent liabilities,” he says. “If there is a risk of contingent liabilities, contractors may be required to indemnify the insolvency practitioner.”

James Abbott

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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.

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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Both experts suggest that to maximise the tax benefits of the process, contractors should ideally seek professional advice a reasonably long time before choosing to enter into a members’ voluntary liquidation. “Pre-planning can pay dividends – literally,” jokes Abbott.

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