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Client Briefing Note

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The risk of retaining excess cash and investments in an owner managed company

Many owner managed companies retain a large part of their profits within the company rather than distributing them in order to minimise Higher Rate Income Tax liabilities for the owner manager however, without careful planning, a buildup of retained profits, cash or investments on the balance sheet may lead to significant tax liabilities and the loss or restriction of certain tax reliefs in the future.

Retained profits

Retained profits will at some point in the future require to be drawn down, for example, if the company ceases to trade or is wound up on the retirement of the owner manager. It may be possible to leave the company structure in place and simply draw the retained profits from the company as dividends over a number of years in order to minimise Higher Rate Income Tax liabilities however, where the level of retained profits available for distribution is large or the individuals concerned have income from other sources, it may not be possible to do this. In addition, failure to wind up the company following the cessation of trade may result in restrictions on Entrepreneur's Relief for Capital Gains Tax purposes and Business Property Relief for Inheritance Tax purposes.

When a company with distributable assets of more than £25,000 is subject to an informal winding up, the distribution of assets on winding up is automatically treated as dividend income which could result in significant Higher and Additional Rate Income Tax charges being incurred. It is not possible to attain capital treatment without a formal winding up which can be costly. Where the distributable assets of the company are less than £25,000, the distribution of the assets will be treated as capital rather than income and subject to Capital Gains Tax which, with the potential availability of annual exemptions and Entrepreneur's Relief, may be at a substantially lower rate.

Cash and investments

In some circumstances, HMRC will seek to deny or restrict Inheritance Tax and Capital Gains Tax reliefs on shareholdings if excess cash or investments are retained by the company.

Business Property Relief is a relief that reduces the taxable value of property on which Inheritance Tax is charged. Shareholdings in unquoted companies will qualify for 100% Business Property Relief providing that they are owned for two continuous years before death or transfer and meet certain conditions. Businesses which are classified as wholly or mainly (more than 50% of their business activities) making or holding investments are specifically excluded from this relief. A build up of cash or investments on the balance sheet could therefore result in the company being classified as an excluded business and the shareholdings no longer qualifying for Business Property Relief. Even if the company is not considered to be an investment company, surplus cash and investments held by the company could be treated by HMRC as excepted assets on the basis that they are not required for an identifiable purpose and therefore be excluded from receiving Business Property Relief.

Entrepreneur's Relief is a relief that reduces the rate of Capital Gains Tax payable on the disposal of a qualifying business asset from 18% or 28%, to 10%. Various conditions must be met in order to qualify for this relief and one of the conditions that applies to shareholdings in an individual's personal company or assets owned personally by an individual and used in their personal company is that the company must be trading. A trading company is classified for Entrepreneur's Relief purposes as "a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities". "Substantial extent" is not defined but is widely interpreted by HMRC to be more than 20% i.e. at least 80% of the activities of the company must be trading activities. A build up of cash and investments on the balance sheet could result in the company no longer qualifying as trading for Entrepreneur's Relief purposes.

Business Asset Gift Relief is a relief that defers the taxation of the Capital Gains arising on the gift or transfer below market value of a qualifying business asset by rolling the gains over against the base cost of the individual or company who receives it, subject to meeting certain conditions. This relief can be a very useful tool in succession planning for owner managed companies for example when transferring shareholdings to other family members. For shareholdings in an unquoted company to qualify for Gift Relief, it must be classified as a trading company using the same definition as set out for Entrepreneur's Relief above.

Use of pension contributions for tax efficient profit and cash extraction

To help mitigate the issues highlighted above, it may be possible for the company to pay employer pension contributions as a means of extracting profit and cash from the company in a tax efficient manner. Employer pension contributions are an allowable deduction for Corporation Tax purposes.

The amount that the company can contribute in respect of an owner manager should reflect the input provided by the owner manager to the company. There is an annual cap however it is also possible to utilise unused allowances for earlier years.

The rules regarding pension benefits are subject to some changes with effect from April 2015, with the key points being the ability to access pension funds from the age of 55, the removal of the need to buy an annuity by increased access to flexible drawdown schemes and the relaxation of tax charges on pension funds left invested. As before, 25% of the pension fund can be withdrawn as tax free cash and there is now scope to withdraw a combination of income and tax free cash.

It will be possible for pension policyholders to draw an income at a chosen level and vary this from year to year in order to extract the income at their lowest rates of tax. There are also ways of diverting the income to spouses, children, trusts and limited companies. These methods could be used in conjunction with the pension fund withdrawals to create a tax efficient retirement pot from the funds currently held in the company.

Rennie Welch LLP accept no liability on the basis of this note and detailed advice, taking into account individual circumstances, should be obtained before entering into any transaction. If you require assistance or advice in connection with the tax efficient extraction of profits or any other tax matter, please contact Lynn Miller at Rennie Welch on 01573 224391 or by email at lynn.miller@renniewelch.co.uk.

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