Chapter 20

Extracting funds from the company

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SIGNPOSTS

- **Surplus profits: retain or extract?** – There are various potential issues to consider in the decision whether to retain or extract surplus profits from the family or owner-managed company. For example, retaining profits in the company may be attractive to some individual shareholders if entrepreneurs' relief would be available on a disposal of their shares. It is possible to extract funds or value from the company in a number of ways. The overall tax cost of the various extraction methods will vary, and it is important to determine the tax implications and efficiency of each one in advance (see **20.1–20.6**).
- **Capital receipts versus income receipts** – A purchase of the company's own shares, liquidation or sale of a company tend to be the most common 'exit routes' for shareholders of family or owner-managed companies. The tax liabilities under the income and capital routes should be compared well in advance of these transactions, in order to determine the most tax-efficient route (see **20.7–20.8**).
- **Bonus versus dividends** – Factors to consider in the decision whether to extract company profits as bonuses or dividends include the NIC impact on bonuses, the national minimum wage and national living wage rules (where applicable), the level of the company's distributable reserves in relation to dividends, the 'dividend allowance', and whether the company has tax losses (see **20.9–20.20**).
- **Implications of paying a bonus** – These include corporation tax relief (if the bonus is commercial and not excessive), the timing of relief for accrued remuneration, PAYE/NIC and cash flow, and reporting requirements under real-time information (see **20.21–20.25**).

- **Payment of dividends** – Any such payments must comply with company law requirements. The 'bonus versus dividends' decision will often also be influenced by factors including pension provision, protecting the state pension and social security benefits, the effect on share valuations, the spread of shareholdings, and personal borrowing. There is no substitute for doing the relative computations to compare the combined effective tax rates (for the company and its owner-manager(s)) for each extraction method (see **20.26–20.28**).
- **Remuneration paid to other family members** – Tax savings are often possible if income can be paid to other members of the owner-manager's family in order to use their annual personal allowances and benefit from their lower marginal tax rates. However, remuneration payments must be commercial and not excessive in relation to the duties performed, and care is needed to ensure that dividends to spouses (or civil partners) or other family members are not 'caught' by anti-avoidance provisions (see **20.29–20.38**).
- **Charging rent for personally owned assets** – The company's owner-managers will sometimes own the trading property (and/or other assets used in the company's trade) personally. In such cases, the owner-manager can extract funds from the company by charging it a market rent for the use of the property. In addition to the tax effects of extracting profits via rent, issues to consider potentially include SDLT, the implications for entrepreneurs' relief purposes on any subsequent 'associated disposal' of the property, and VAT (see **20.39–20.43**).
- **Selling an asset to the company** – Owner-managers might consider extracting a capital sum from their company by selling personally owned assets (eg trading premises) to the company. Issues to consider potentially include SDLT for the company, CGT for the vendor on a capital gain, and VAT (see **20.44–20.46**).
- **Charging interest on loans to the company** – Owner-managers who make loans to the company, or have credit balances on their current account, could consider charging the company interest on the loan or credit balance, up to a commercial rate. Corporation tax relief would generally be available to the company under the 'loan relationship' provisions (see **20.47–20.49**).
- **Loans from the company** – Such loans (including overdrawn director's loan accounts) will generally have implications for closely controlled companies under the 'loans to participator' rules, and benefit-in-kind implications for owner-managers under the 'beneficial loan' provisions. Anti-avoidance provisions aimed at circumventing tax charges under the loans to participator (and also benefits to

participators and return payments to the company) rules may also need to be considered. If loans to shareholders are waived, further tax (and NIC) implications potentially arise (see **20.50–20.72**).

- **Benefits-in-kind to non-working shareholders** – Expenses or benefits provided to a close company shareholder (or an associate of a shareholder) may be taxable as distributions, unless the expense or benefit is already taxed under the employment income rules in *ITEPA 2003* (see **20.73**).
- **Appendix** – A planning checklist of strategies for extracting funds from the company is included at **20.74**.

SHOULD SURPLUS PROFITS BE RETAINED OR EXTRACTED?

Main issues

20.1

Focus

Family and owner-managed companies can freely decide how much of their profits should be returned to the shareholders or retained within the business. The 'working' shareholders will need to extract a basic level of income from the company to satisfy their personal requirements.

Hitherto, the comparatively lower income tax rates tended to encourage companies to extract surplus profits. Companies that relied on bank borrowings or institutional finance may, however, have been prescribed financial limits on the amount of dividends and other payments which can be made to the owner-manager shareholders.

From a commercial perspective, the company's cash flow and working capital requirements must be considered when determining the timing and amount of funds to be taken out. Given that the extraction of funds (see **20.5**) gives rise to a tax charge, which will be particularly expensive where large sums are involved, there is little point in taking them out by bonus, dividend, etc unless they are required by the owner-manager for their personal/family's needs. With the current high levels of income tax rates many owner-managers are likely to retain more profits within their companies. Within these constraints, some owner-managers may still wish to regularly remove 'surplus' cash from the business so as to remove it from any further business risk (subject to the

requirements of the *Insolvency Act 1986*, for example, the 'two year' look-back period for 'preferential' or 'under-value' transactions under *IA 1986, ss 238* and *239*).

A further factor to consider is the potential double charge to tax, which arises where profits retained in the company are invested in appreciating assets. The appreciation in asset values could potentially be taxed both in the company and when the value is realised by the shareholders, perhaps on a sale or liquidation of the company. However, if the company is eventually sold for a price based on a multiple of earnings, the value of the shares may bear little relationship to the level of retained profits. Furthermore, the 'double charge' effect would not be a problem where the company's shares are to be passed down as a family heirloom on death. Owners of personal service companies are effectively forced to extract 'tainted' income and additional factors will come into play.

Entrepreneurs' relief (ER) and investors' relief (IR)

20.2 Owner-managers of trading companies enjoy particularly favourable CGT treatment, with a current 'exit' ER CGT rate of 10% (up to a cumulative lifetime gains, limit of £10 million). However, since 6 April 2016, all other 'non-ER' significant gains are taxable at 20% (except those arising on the sale of residential property).

Finance Act 2016 introduced Investors Relief (IR), which provides a 10% CGT-rate of the disposal of qualifying shares after three years. Like ER, the IR 10% CGT rate is subject to a separate £10 million lifetime gains limit. As a general rule, 'business angels' should normally be eligible for IR but employees and 'paid' directors cannot qualify.

Retention of profits

20.3 With a current ER limit of £10 million, the overall tax costs of realising retained profits as a capital gain (for example, by liquidation or sale – see **20.4**) have remained identical to the pre-6 April 2008 business taper regime (assuming the (cumulative) gains are below £10 million).

Retained profits only suffer corporation tax at the company's marginal tax rate and may ultimately be realised at low CGT rates.

The ability to reinvest profits within company structures at relatively low tax rates has encouraged many sole traders and partnerships to incorporate their businesses. For 2017/18, unincorporated businesses earning substantial profits will generally suffer a marginal 47% combined income tax/Class 4 NIC rate

on their profits, regardless of whether the profits are 'ploughed-back' within the business or extracted.

All companies pay corporation tax at 19% from 1 April 2017 (previously 20% since 1 April 2015). Thus, the total effective rate of taking profits as a capital sum is 27.1% (ignoring the impact of any base cost, etc) calculated as follows:

	£
Profit	100
Corporation tax at 19%	(19)
Retained profit = chargeable gain	81
CGT @ 10% (assuming ER)	(8.1)
Net realisation	72.9
Total effective tax rate	28%

If ER is not available at the time the retained profits are taken as a 'capital distribution', the overall effective rate increases to 35.2% (assuming a 20% CGT rate). The rates on retained profits compare very favourably with the current top income tax rates.

Taking profits as capital gains

20.4

Focus

Unless the owner-manager is making a complete, or almost complete, 'exit' from the company, it may be difficult to find an effective method of converting profits into a capital sum. Taking the profits as a capital distribution on a subsequent winding-up is not a realistic option if the business is continuing.This means that the individual will have to sell their shares either back to the company or by way of an external sale.

Given the relatively wide gap between CGT and dividend tax rates, HMRC are likely to use the Transaction in Securities rules where shares in close companies are sold to a commonly controlled company, Employee Benefit Trust, pension fund, etc but not normally on commercially driven sales to third parties. However, unless there is *complete certainty* that transaction will satisfy the post-sale 'no-connection' test, it is recommended that the advance clearance procedure in *ITA 2007, s 701* is used to obtain assurance that HMRC are satisfied that the transaction is not driven by the avoidance of income tax.