

ALAN PINK TAX

PROFIT EXTRACTION – TIME FOR AN UPGRADE?

Building tax efficient structures for businesses is a bit like building cars or computers. Nothing stands still, and the mechanism that was the “latest thing”, or the “best buy” a few years ago may no longer be such these days.

A good example of this is the practice of transferring capital assets into your limited company. This was all the rage a few years ago, especially when there was a flurry of new limited company incorporations to take advantage of the lower rates of corporation tax introduced by Gordon Brown. These rates, of zero per cent or ten per cent, are no longer with us, having been replaced by a sliding scale of rates between 21% and 28%, however the basic rationale behind the planning is just as valid now as it was then (I use these words advisedly).

The idea runs like this. Your big problem, as an owner managed business running a limited company, is getting the profits out of the company and into your own hands. No-one runs a business just to enrich a limited company, but to enrich themselves, or at least keep the wolf from the door. So it's not much use saying: “Aren't we clever? We've made several hundred thousands of pounds of profits and only pay 21% tax!” That's true as far as it goes: companies pay corporation tax at 21% on profits of up to £300,000 in a year, but its not much use if the profits have to remain languishing in the hands of the limited company and can't be used by you personally.

It's true, you can take dividends out of the company and, up to a point, this is quite a tax efficient thing to do. Dividends don't normally attract any national insurance liability and, providing their gross amount is no more than your basic rate limit for the year (about £40,000), you've got no personal tax on the dividend at all. The income tax liability is treated as being “franked” by the corporation tax the company has paid.

But what if your lifestyle costs more than this? What if you want to take some of the money of the company to reduce your personal borrowing, such as your home mortgage or other personal loans? The size of most

such loans these days, you're not going to be able to make much of a bite out of them from the loose change of £40,000 a year.

And if you're one of those people who are lucky enough to be sitting on a cash deposit in your company, surplus to the needs of the business, it can be particularly frustrating having to continue with large personal borrowing, and solely because of the taxman.

The reason tax is such an obstacle to extracting money from the company is because, once you get over the approximately £40,000 basic rate limit, HM Revenue & Customs take a thumping great 25% of any dividends you pay yourself. Remuneration, bonuses etc aren't usually any better, indeed can be quite a bit worse, because as well as income tax you're paying national insurance, at rates of up to 23.8%.

Some people are driven to the extremes of winding up their companies in order to get the money out, but in most cases this can cause more problems than it solves. So let's have a look at this package, Tax Planning 1.0, that was introduced some years ago to solve this problem.

Profit Extraction 1.0

At its simplest, and most timid, Profex 1.0 works something like this. A sole trader or partnership business might be incorporating as a limited company. Assuming it is the kind of business that has an inherent "goodwill" value, which most profitable businesses do, the idea was to "sell" the goodwill to the limited company for the maximum value that you could without paying capital gains tax. When the capital gains tax annual exemption was about £8,000, and business asset taper relief applied (which it did until nearly a year ago) you could sell your goodwill to the company for say £30,000 per partner and pay no capital gains tax. This is because, after tapering the gain of £30,000 by 75% the result was £7,500, which was below your annual exemption. Fine, providing you have no other capital gains in the same year.

So it was possible to set up a credit balance in your favour in the company's books which you could then draw down tax free.

The abolition of taper relief has rather hampered this basic form of planning, but you can still get some benefit out of "entrepreneur's relief" which can give you about £17,000 tax free.

And it didn't matter if the "true" value of the goodwill concerned was more than the figure you would put on it for the purposes of the transfer. Any excess value could be "held over" so that no tax would arise.

As I say, all perfectly valid planning still. But not very exciting.

Properties

What's more, there are only a limited number of situations where you are able to do the goodwill introduction trick. If you've already been running your business as a limited company, perhaps for some years, it's not going to be possible, in most cases, to say that you own the goodwill of the business personally, outside the company. The presumption has got to be, normally, that the company owns the goodwill of the trade.

The most common type of asset other than goodwill that you can do this sort of planning with is real property. Very often the owner managers of the company will hold a property, from which the company carries on its business, outside the company. According to Profit Extraction 1.0, it may well be a good idea to do the same sort of thing with such a property as I have described using goodwill. Let's say you bought the property some years ago for £100,000 and it is now worth £150,000. By transferring it into the company at say £110,000, you bring about the situation where the company owes you this figure, and can pay it to you tax free out of its post corporation tax reserves. The balance of the gain, that is between the true value of £150,000 and the value you have put on the property of £110,000, can be "held over".

There is a mammoth problem with Profex 1.0 which becomes particularly acute in the case of properties, and I'll come on to that, but it's worth mentioning that there is a lesser problem in introducing properties to limited companies, but one which can be particularly painful: Stamp Duty Land Tax.

Where any real property situated in the UK is transferred to a limited company SDLT is payable on the basis of the market value of the property. Yes, it is the market value, not the value you put on the transfer for accounting purposes. So in my example of the property that's worth £150,000, SDLT will be payable on this figure.

Objectively speaking, you could say that SDLT shouldn't be a "deal breaker". After all, the maximum rate of SDLT is 4%, and if you are avoiding paying 25% income tax on the value you are then able to extract from the company, surely this makes a lot of sense? But a lot of people feel instinctively that it just hurts too much to pay this tax on a transaction you have invented yourself, where there has been no real change in ownership or the underlying commercial situation.

As well as properties, you can look at other intangible assets other than goodwill. These include such things as computer software rights (where they are vested in the individual name) or other patented or non patented "know how". Be careful on know how, though, because HMRC seem to be getting very suspicious about transfers of know how to companies, asking to see evidence that transfers have actually taken place.

Intangible assets are much better than property for a number of reasons whilst using Profex 1.0. One particular benefit of introducing goodwill or other intangible property is that, in the event of the company going bust, these assets are likely to be worthless any way – unlike the property which you would lose in an insolvent liquidation of your company.

Upgrade to Profit Extraction 2.0

Despite the solid benefit of being able to draw out potentially large sums of money from your company at zero or low rates of tax, there is one major downside to this version of profit extraction planning which, as I have said, is particularly acute in the case of properties. It's also a problem, though, wherever you have a type of asset that might increase in value in the future.

Put simply, if somewhat melodramatically, what you are doing is putting the asset concerned into tax "prison".

Let's take the case of a property, because that's most likely to be where the problem shows itself.

On ultimate sale of a property, held outside your company and used for the purposes of its trade, you will pay either 10% capital gains tax or 18%, depending on whether you are disposing of any shares in the company at the same time, and on a number of other factors. Put the property inside the company, though, and the absolute minimum tax the company will pay on any gain (assuming current rules and rates throughout) is 21%. The effective rate of tax could, and in a great many cases is likely to be, nearly

30%. So far so bad. But you have then got another layer of tax when the post corporation tax proceeds are taken out of the company by yourself. This could be 10% at best and 25% at worst. So your overall tax rate on the gain is effectively somewhere between 30% and 47% approximately, that is somewhere between twice and three times the amount of tax you would have paid if you kept the property in your own name.

What's more companies can't get out of tax completely, as you might be able to, by becoming non UK resident.

I've ignored "indexation allowance" in the above summary, partly for simplicity, but partly because indexation is based on retail price inflation, and therefore is pretty insignificant at the present time.

So that's why I personally come out in goose bumps at the idea of appreciating assets like properties being introduced into limited companies. Profex 1.0 works better with intangible assets.

Profit Extraction 2.0

Let's sum up where we have got to so far. The old fashioned planning has the advantage of providing a way of getting money out of your company tax free or at a low rate of tax. But its disadvantages are firstly that you put the assets into tax "prison", and secondly that you are limited as to how much value you can put on the assets introduced without paying capital gains tax. In the example of the property, for example, we needed to restrict the transfer value to £110,000, because if we had put the true market value of £150,000 down, this would have resulted in a tax charge on the £50,000 gain. Whilst arguably it's still worth doing, because the capital gains tax is less than the income tax you would have paid, it does take the gilt off the gingerbread rather, particularly if you're not going to be saving the income tax this year, but are still going to have to pay the CGT. So Profex 2.0 has been developed to get you the same practical result but without those fairly major disadvantages.

This is how it works. Instead of carrying on your business through the medium of a limited company, you set it up as a partnership, including the company as one of the members. This could be either a general partnership or an LLP, the only major difference between the two being the limited liability that the latter gives. Instead of introducing whatever asset it is, being intangible or property, into the company, you introduce it as capital into the partnership. The accounting for this is similar to the accounting for

transferring an asset to a company, but subtly different. You are credited with the value of the asset you have put into the partnership, and this therefore becomes a figure on which you are entitled to draw down either immediately or in stages, depending on the business' cash flow.

How does this solve the two problems with the 1.0 version, though? The asset, held within the partnership, can be so arranged as to be treated for tax purposes as if it were still owned by you personally. It's all a question of getting the partnership agreement right. So the asset isn't in tax "prison", but can still give rise to 10% or 18% capital gains tax maximum on sale.

By the same token, the introduction of the asset need not give rise to any capital gains tax charge if you write the paperwork right. This is because you can arrange things in such a way that there is no deemed "disposal" for CGT purposes on the introduction.

It's even possible, under Profex 2.0, to avoid SDLT if the asset you are putting in is a property, but this can take a bit more jumping through tax hoops.

The Next Version?

All this no doubt sounds brilliant as far as it goes, but can it be improved on even further? I think the answer is "yes".

The question is sometimes asked, "what happens when we run out of credit?" It's all very well putting £1 million worth of assets into the partnership, say, and then drawing down £1 million over the years to pay off home mortgages, or spend on wine, women and song, but when you get to the end of that £1 million is there anything else that can be done?

In what you might call Profit Extraction 2.1, there is. If the asset is re-valued upwards by then in the books of the partnership, to reflect an actual increase in its market value, the accounting credit which results from re-valuation can be posted to your personal capital account with the partnership/LLP. In this way if the asset is the sort which steadily appreciates over a long period, which property has historically always done, you can end up repeatedly replenishing the credit you have with the business, enabling more and more draw downs to be done in the future.

Accounting standards can get in our way where we are talking about intangible assets however. I get different messages from different

accountants on this one, but there is a general view that you cannot value up things like goodwill which have been internally generated within the business.

OK, then, what about Profex 2.2? Under this idea, you could transfer your whole partnership business to a new partnership or LLP, and this could take place at the new value of the assets including goodwill etc. If the interests of the partners in the new partnership are identical to those in the old, it seems that no capital gains tax disposal has happened, nor should any other tax charge arise.

So Version 2.2 could just be a neat way of circumventing the accountants rules, but it's definitely not something you would do unless you had to, firstly because of the upheaval of changing the trading entity, and secondly because accountants don't like their rules being circumvented!

A New, Powerful Tool

Anyone who has cash in his company that he wants to get out, but has despaired of doing so for tax reasons, should look to see whether this new tax planning tool might be the thing for him. Don't assume that the old planning is the best that can be done!

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