Cash in reserve

CRAIG SIMPSON examines the treatment of surplus cash in a company.

When is the level of surplus cash in my company too high to cause me a tax problem? This is a common question asked by many a trading company client over the years. Readers will be familiar with this discussion but it should be considered from a tax *and* commercial basis because focusing purely on tax may be a costly mistake in the long run.

The answer to the question of surplus cash is the classic 'well, it depends'. This elicits a collective groan from clients, but it is true. The problem with surplus cash and tax legislation is that the answer is not always straightforward and we tend to feel uncomfortable when there is no rigid set of rules to follow. A reasonable conclusion might be that we have probably become overly excited about surplus cash in a trading company affecting the tax status of the company. This is on condition that the cash is left to do nothing other than earn deposit interest.

Broadly, there will be two concerns in the adviser's mind when thinking about surplus cash in a trading company or trading group. The first will be the trading status of the company for entrepreneurs' relief purposes. The second will be status of the shares in the company for business property relief (BPR).

Let us recap. One condition for the shares in a company to qualify for entrepreneurs' relief is that it has to qualify as a trading company or the holding company of a trading group defined in TCGA 1992, s 165A(3) and s 165A(8). In both cases, the company or group activities do not include to a substantial extent activities other than trading activities. 'Substantial extent' is less than 20% (see HMRC's *Capital Gains Manual* para CG64090).

For BPR, the test is different. In the context of surplus cash for a standalone company, BPR will not be available for shares in a company if the business carried on by the company consists wholly or mainly of making or holding investments (IHTA 1984, s 105(3)).

The wholly or mainly test is a quantitative 50% test, the practical application of which has evolved with case law. HMRC interprets 'mainly' to mean 50% or more. Based on the decision in *Farmer & Giles (Farmer's Executors)* (SpC 216), HMRC, in ascertaining the type of business carried on, includes turnover, profit, capital employed and management or employee time and expenses.

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For IHT, there is also the excepted assets test to consider (IHTA 1984, s 112). Even if the shares in the company qualify for BPR, surplus cash could be an excepted asset and excluded from the BPR calculation and hence attract IHT.

KEY POINTS

- Consider the company's trading status for entrepreneurs' relief.
- The use of a holding company should be considered to provide basic asset protection from the trading company.
- Investment business demergers could also be considered.
- A company above the trading company could own income-only shares in the trading company or group.

Looking back

There has been little case law on surplus cash and entrepreneurs' relief. In Budget 2016, the government said it would review the definition of trading company for entrepreneurs' relief purposes to ensure it 'operates effectively'. This is likely to be as a result of cash boxing in trading companies, which happens when companies retain surplus cash, then sell it through an increased price for the shares in the company and then claim entrepreneurs' relief.

I anticipate some sort of excepted assets test for entrepreneurs' relief along similar lines to the IHT requirements and that surplus cash may be carved out of the calculation and taxed at either 20% CGT or, worse, dividend tax rates. More importantly, it is possible that such a change in law or HMRC approach could be retroactive.

But enough of the scaremongering – what are the solutions to this problem? First, a simple and commonly offered piece of advice is not to invest the cash in the trading company. The cash is left on deposit, earning little interest, but the trading status of the company is protected. But this advice has disadvantages. The company may never be sold, and so the cash sits in the company earning little interest and exposed commercially to the failure of the trading company. All being well, a buyer comes along and the shareholders should benefit from entrepreneurs' relief through a share sale, with the surplus cash being taxed at 10%.

Commercially this may look good on the face of it, but suppose that client had considered investing the surplus. What return could have been made on the money in the interim, and would the tax saving be worth it?

My angle here is that, commercially, there may be a better longer-term answer for the client. The following are some practical solutions to this problem based on advice I have given recently.

Basic asset protection

The use of a holding company should be considered to provide basic asset protection from the trading company. The holding company can be inserted by way of share for exchange relying on TCGA 1992, s 135. An HMRC clearance application should be made under TCGA 1992, s 138 and ITA 2007, s 701.

The surplus cash could then be transferred to the holding company by way of dividend on the assumption that reserves allow. Every case is different and care should be taken to ensure such a tactic is not an attempt to put money beyond the reach of creditors. Any investment activity undertaken with the cash must not breach the holding company of a trading group test set out above.

Investment business demerger

The launch of an investment business should be considered. The cash surplus may be substantial and the client may want to diversify their assets away from the trading company environment.

This may present an opportunity for IHT planning through a family investment company where other family members might be introduced into the share ownership. The reduction in corporation tax rates in recent years and the tax treatment of dividends can make this an attractive investment accumulation vehicle.

How would a demerger be achieved without the expensive tax cost of extracting the cash first? The steps might be:

- A new holding company (Holdco) is inserted above the trading company by way of share-for-share exchange with mirrored shareholders relying on TCGA 1992, s 135. Holdco would issue enough share capital to allow for the later capital reduction demerger of the value of the surplus cash/investment business.
- The surplus cash is moved to Holdco by way of dividend.
- Holdco invests the cash in a new subsidiary company (Investco) in exchange for an issue of shares.
- Investco starts an investment business. There needs to be enough activity for Investco to be a business otherwise the scheme of reconstruction rules will not apply.
- A new company (Newco) is formed with a subscriber share.
- Investco is demerged from the group using a capital reduction demerger (a scheme of reconstruction within TCGA 1992, Sch 5AA, reliance being placed on s 136 and s 139), with Newco issuing equity to the shareholders of Holdco in exchange for the shares in Investco.

HMRC clearance should be sought, but this should be forthcoming when there is a clear strategy to separate the non-core investment assets into a separate investment business.

The result is a demerged investment group away from the trading company, which can be operated commercially as an investment business in the knowledge that the trading group has been cleaned up for tax purposes. Compared with extracting the cash and then investing, the company is in the position to invest the gross cash.

There are potential downsides. The start of the investment business might taint the entrepreneurs' relief status of the company in the short term. But this would be countered by the argument that the investment business would operate only for a short period before the demerger and is unlikely to breach the 20% test in that time when considered in the round.

Demerging an investment business would expose the shares in the investment company to IHT and it would extinguish any hope of an argument that the surplus cash is required in the trade when considering excepted assets for IHT purposes.

But that is not the main point here. Demerging the cash enables the client to focus on a separate investment business and IHT planning is possible through routes such as growth shares in the demerged investment group. Commercially over time the return may be better than any attempted tax saving strategy.

Income-only shares

The demerger is fine as a one-off transaction. But what if the trading company generates surplus cash each year and the client wants to separate that cash into a separate investment company to follow the asset protection and investment strategy, while protecting the tax status of the company or group.

An alternative structure might be to have a company above the trading company owning income-only shares in the trading company or group. Assume there is a standalone trading company, with £1 ordinary shares in issue, which is generating surplus cash each year. The steps might be as follows:

- The existing £1 ordinary share capital is reorganised into A and B ordinary shares. The A shares have income, voting and capital rights; the B shares have income rights only. The B shares represent more than 25% of the ordinary share capital of the company.
- A new company is formed, Investco, with a subscriber share.
- Investco acquires the B shares in exchange for an issue of shares to the B shareholders on a mirrored basis. Since Investco is acquiring at least 25% of the ordinary share capital of the trading company TCGA 1992, s 135 should apply.
- Dividends of the surplus cash could then be paid on the B shares to Investco yearly.

This structure should be approached with caution though. The share-for-share exchange on the B shares will not qualify for stamp taxes relief, so there will be 0.5% cost on the value of the shares issued in Investco to acquire the B shares. This cannot be an arrangement for the avoidance of income tax because there is potential for the settlement legislation to apply – for example, if the shares in Investco were structured via family members to reduce the overall income tax position of a shareholder had he taken the dividends directly from the trading company. HMRC clearance should be sought setting out the commercial rationale for the transactions before implementing such a structure.

Conclusion

There are many variations on the theme of surplus cash but all indicate that there is a commercial consideration to surplus cash that cannot be overlooked. The question 'would I be better off ring-fencing and investing the money than protecting my tax status?' is important but, with the solutions above, the client might be able to have the best of both worlds. ■

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