Hello and welcome to this short video entitled “Investing Corporate Surplus cash – exploring the potential impact on IHT and CGT reliefs.

This video supplements two other videos on Pru Adviser. One focuses on companies investing in Insurance Bonds and the other, on companies investing in OEICs. These videos consider investment opportunities for lazy cash held by companies, surplus to working capital requirements, which often languishes in bank accounts generating a very poor rate of return. They focus on accounting and corporation tax issues.

This video is based on our understanding as at the date you can see in the important information section on the screen.

I’m Graeme Robb, and I’m a Senior Technical Manager in the technical team within Prudential. I’ll take you through this video considering the potential impact on future IHT and CGT reliefs where the company is holding cash surplus to working capital requirements. I’ll consider what impact, if any, a proposed investment will have on these reliefs. Ultimately this is primarily a matter for the accountant to consider but it’s helpful to have an understanding of the issues involved when you’re advising on corporate investment.

The two reliefs that we need to consider are Inheritance Tax Relief for Business Property. More commonly known as Business Property Relief. And Capital Gains Tax, Business Asset Disposal Relief which was formerly known as Entrepreneurs' Relief.
Why are we focusing on these reliefs? Well because they're available to shareholders in private trading companies. And therefore, if a trading company has a surplus cash balance, does that impact on the trading status? Also, does the conscious decision to invest that surplus cash in itself have an impact?

Let's start with IHT Business Property Relief.

IHT Business Property Relief is available at 100% where shares in a private trading company have been held for at least two years.

It's an incredibly valuable relief but you need to bear in mind that the company must be a trading company and not an investment company such as a buy to let company. The company must therefore pass the "trading test".

Not only that, If the company passes this Trading test and is classified as a trading company, then we also need to consider whether this trading company then owns what's called "excepted assets" i.e. non trading assets as these can dilute the Business Property Relief available.

Let's look initially at the trading test.

The good news is that HMRCs test for trading status is pretty generous – unless the business is wholly or mainly investment related then the company will be trading and BPR will be available.

What does that mean for a business with investments?

Providing the business is more than 50% trading then BPR can be available, so your typical family trading business with a bit of surplus cash will easily pass this test. In applying the test, the position should normally be looked at over a reasonable period prior to the transfer, to allow for temporary fluctuations in activity and performance.

In its Shares and Assets Valuations Manual, HMRC state that

It is not possible to lay down any precise ground rules. Each company has to be looked at in the round. It may however be readily accepted that, where the majority of both the tangible asset value and profit of the company is attributable to trading activities, relief is available.

In other words, where more than 50% of the assets and more than 50% of the profits are trading related then BPR is available.

Clearly each case must be decided on its own merits, but in the normal course of events the trading status isn't typically jeopardized by a surplus cash balance or a surplus cash investment. That's good news but not the end of the story.

If that trading company is deemed to hold what called an “excepted asset” then although the shares qualify for IHT relief, the value of that excepted asset will be stripped out to deny relief on that amount. That’s only right & proper otherwise it would be possible for a trading company to shelter non-trading assets on its balance sheet and obtain IHT relief for those investments.

This was considered in a case involving a lady called Mrs Wilkins…

In this case, Mrs Wilkins died holding half the shares in a company. Her husband held the other half. The company's trade was the sale of bathroom and kitchen fittings, mainly to "trade" customers.

On her death, the executors went to claim the Business Property Relief on the shares in her estate.

The company's turnover at the time of the lady's death was approximately £600,000. It held £450,000 in "cash" invested for periods of up to 30 days.

HMRC accepted that the company needed £150,000 but successfully argued that £300,000 was an "excepted" asset.

In other words, her shares qualified for IHT relief but the amount of the relief was reduced to reflect the £300,000 of excess cash.

In that particular case the Special Commissioner was unable to find any evidence that the £300,000 was required for a future palpable business purpose. This case highlighted that…

- Only the value of the excepted asset didn't qualify for Relief, the remaining assets did qualify, and
- Cash is as much as an excepted asset as an investment such as a Bond or OEIC

For future reference, just remember that surplus cash might not be treated as an excepted asset if held for an identifiable future purpose.

Let's now consider Capital Gains Tax Business Asset Disposal Relief.

This CGT relief is hugely valuable and is potentially available to a client disposing of shares in a trading company.

For lifetime gains up to £1m it delivers a CGT rate of just 10% assuming certain criteria are met.

For the purposes of this video, the condition that we're interested in, is that Companies must be 'mainly' trading in the 24 months prior to sale if relief is to be potentially available.

It’s accepted that companies may not be 100% trading and with that in mind, a trading company is defined as one which doesn’t carry on non-trading activities to a substantial extent.

In the opinion of HMRC ‘substantial’ in this context means more than 20%.

There is no simple formula but instead measures or indicators should be considered. For example,

- Income from non trading activities
- Time spent by directors looking after investment activities, and
- The company’s asset base

These indicators shouldn’t be regarded as individual tests, but should be applied “in the round” although in the context of a bond investment for example, the “asset base” test (alone) might be conclusive since a bond doesn’t produce income and it certainly doesn’t use up directors’ time in the same way that a property letting portfolio for example might do so.

As a rule of thumb, making an investment will not count as a trading activity albeit that the short-term lodgement of surplus funds, for example in an interest-bearing deposit account could count as a trading activity. In saying that, the long-term retention of significant earnings generated from trading activities may amount to an investment activity.

In summary, for business owners contemplating a disposal of shares, the accountant will carefully monitor compliance with the 80/20 split so as not to risk losing relief. In many cases however, the amount of surplus cash will sit comfortably within that 20% limit meaning no impact on the relief.

That’s us at the end of this short video and I hope its been of use.

If you wish to discuss matters further then please contact your Prudential Account Manager. You can also access our Knowledge Library within Pru Adviser for further information. In particular, these articles may be useful.

Thank you very much for your time.