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Investing surplus company cash

All companies need working capital that is readily accessible as and when they need it. In these circumstances, the company bank account is likely to be the most sensible place to deposit it. But if they have more on deposit than they need, is this surplus cash working hard enough for them?

Why is it a good time to look at a bond for surplus cash?

One key reason is the low interest rates. Directors could be increasingly concerned at poor returns available on deposit accounts.

However, despite this they will have the comfort of knowing the funds will be available when they may be required. Therefore, a second key reason to consider a bond for surplus cash is that directors may be looking for any returns to be 'smoothed' and this could be possible in an insurance bond wrapper.

It's important to remember the value of any investment can go down as well as up and your customer might get back less than they have put in.

In addition to the above here are some other reasons to consider why an investment in a bond could work for a company investment:

- **'Basic rate credit' mechanism** – tax rules give recognition to the fact that UK bonds will have suffered life fund taxation. Although tax is treated as having been paid at 20% basic rate, the effective tax rate applying to the fund is always less than 20%. Dividends are exempt from tax; gains are taxed at 20%, and where certain capital gains are made on or after 1 January 2018, then indexation allowance will be applied, calculated up to December 2017.
- **No 'surrender penalties'** – although a bond is seen as a medium to long term investment, directors can access it without any penalty or having to leave it invested for a fixed term – they can get their money when they need it. Although the bond itself won't suffer any surrender penalties, it's important to remember that some funds might.

The combination of these factors mean that an investment bond, with an appropriate underlying fund choice could be a more attractive investment opportunity for a company's surplus cash rather than it sitting on deposit.

Tax treatment of a company owned bond

This is an important area to understand.

How a company is taxed depends on what 'size' of company it is. Micro-entities can use historic cost accounting for insurance bonds. Larger companies use fair value rules.

The following hypothetical examples show the difference the two accounting methods have on how the bond is taxed.

A company will be considered a Micro-entity if it has any two of the following:

- A turnover of less than £632,000
- £316,000 or less on the Balance Sheet
- 10 employees or less.

Corporation Tax rates

The following are hypothetical examples to show the different tax methods an investment bond could be taxed under, depending on the size of the company. The figures used are in no way related to any specific investment fund or potential returns. The information is also based on Prudential's current understanding of the Law and HMRC rules and practice.

Corporation tax rates		
Financial year 2020/21	Financial year 2021/22	Financial year 2022/23
19%	19%	19%

Historic cost accounting – accounting year end 31 March

- The company invests £200,000 in September 2020
- At 31 March 2021, the value of the bond is £210,000
- At 31 March 2022, the value of the bond increased to £230,000
- In April 2022 the company cashes in the bond for £230,000

Period to 31 March 2021 – historic cost £200,000

- no tax consequences

Period to 31 March 2022 – historic cost £200,000

- no tax consequences

Period to 31 March 2023 – cashed in for £230,000

- Gain: £30,000
- Grossed up (as underlying fund has effectively been taxed at 20% whilst in the bond): £30,000 x 100/80 = £37,500
- £37,500 profit taxed at 19% = £7,125
- Available for current year offset = (£7,500)

As the tax has already been paid in the bond, a 'basic rate credit' is applied which is offset against the Corporation Tax liability in this year – so no tax to pay.

Fair value accounting – accounting year end 31 March

- The company invests £200,000 in September 2020
- At 31 March 2021, the value of the bond is £210,000
- At 31 March 2022, the value of the bond increased to £230,000
- In April 2022 the company cashes in the bond for £230,000

Period to 31 March 2021 – bond valued at £210,000

- Increase of £10,000 x 19% (Corporation Tax) – £1,900 tax due

Period to 31 March 2022 – bond valued at £230,000

- Increase of £20,000 x 19% (Corporation Tax) = £3,800

Period to 31 March 2023 – cashed in for £230,000

- Profit = £30,000 (£10,000 + £20,000)
- Profit grossed up (as underlying fund has effectively been taxed at 20% whilst in the bond): £30,000 x 100/80 = £37,500
- From that grossed up gain, we can deduct £10,000 and £20,000 as those amounts have already been taxed in the periods ended 31 March 2019 & 2020. That leaves a figure of just £7,500.
- £7,500 profit tax at 19% = £1,425
- Available for current year offset = (£7,500) – this is same 'basic rate credit' as in the historic cost accounting example.

The £1,425 Corporation Tax due in the period ended 31 March 2023 is covered by the £7,500 'basic rate credit', with the remaining £6,075 available to offset against any other tax liability in the accounting period.

Impact on tax reliefs

There are two tax reliefs we'll look at in relation a company investing in a bond. These are:

- Inheritance tax Business Property relief (BPR)
- Capital Gains Tax (CGT) Business Asset Disposal Relief

Inheritance tax BPR

If a shareholder in a company dies, then three conditions need to be satisfied to obtain 100% relief:

1. The ownership test
2. The investment test
3. The excepted asset test

Each company's circumstances will differ and therefore, will need to be evaluated individually. However, the key points are covered in this table:

IHT Business Property Relief (BPR)		
Ownership test	**Investment business test**	**Excepted assets test**
Must have owned business for at least two years before death Bond has no impact on this	No relief where the business consists wholly or mainly (i.e. 50% or more) of investment activities	Excepted assets must be excluded for BPR purposes Needs to pass test for it NOT to be treated as an excepted asset – see below
In order for an asset of the business NOT to be treated as 'excepted', it must pass one of two tests: 1. It has been used wholly or mainly for business purposes in the last two years, or 2. Must be required at the time of transfer of value for future use for the purposes of the business in question		

Surplus funds held for no identifiable business purpose are likely to be treated as an 'excepted asset' whether in cash or whether invested – so switching from cash to bond (or vice versa) should have no impact on the availability of BPR.

CGT Business Asset Disposal Relief

For lifetime gains up to £1m, Business Asset Disposal Relief delivers a CGT rate of 10%. It is a very valuable relief. The company must be 'mainly' trading in the 24 months prior to sale. HMRC apply a 20% benchmark and therefore any investment activities must be kept within this to qualify for relief.

There is no single indicator when considering this 20% test. Instead the test should be applied 'in the round' – this means that there could be other indicators to consider when establishing if it's a non-trading activity. You can find out more details on the HMRC website: **gov.uk/hmrc-internal-manuals/capital-gains-manual/cg64090**

In the case of surplus cash or an investment of those funds, it would seem logical to primarily focus on the asset base of the company when considering the 20% test. Ultimately, if a sale of the business is planned, then the accountant will monitor the position to ensure the 20% test isn't breached in the 24 months prior to sale. This might simply involve spending or extracting some of those surplus funds.

Paying for advice

The best course of action is to speak to the company accountant to agree the most appropriate way. Companies are used to dealing with invoice payments so it may be that invoicing them for any adviser charge is the simpler approach rather than the insurance company facilitating the advice charge.

Summary – things to consider for your corporate clients

When speaking to a client about corporate investing, some of the things to consider as part of your full fact find with them include:

- Is there surplus cash to invest?
- Are the low interest rates a concern?
- Would the possibility of smoothed returns be attractive?
- What accounting method is used and what impact this has on the amount of tax to pay?
- What is the potential impact of surplus cash on any tax reliefs available?
- What would be the preferred way to pay for the advice you give?

To find out more about any of this, or what investment options are available from Prudential, please get in touch with a Prudential Account Manager.

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