HMRC internal manual

Business Income Manual

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BIM45700 - Specific deductions - interest: Withdrawal of capital from a business

This chapter applies for Income Tax purposes to the computation of trade profits and property income. References in the text to a 'business' should therefore be taken to include both trades and property businesses. The chapter does not apply for Corporation Tax purposes, where there are separate rules in the loan relationships legislation (see CFM30000 (https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm30000)).

S34 Income Tax (Trading and Other Income) Act 2005

A proprietor of a business may withdraw the profits of the business and the capital they have introduced to the business, even though substitute funding then has to be provided by interest bearing loans. The interest payable on the loans is an allowable deduction. This is on the basis that the purpose of the additional borrowing is to provide working capital for the business. There will, though, be an interest restriction if the proprietor's capital account becomes overdrawn, see BIM45705 (https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim45705) onwards.

Example 1

Daphne talks to their bank manager about how well the trade is doing and the manager agrees to increase the business overdraft facility by £10,000. Daphne increases the level cash drawings from the trade by £1,000 a month, so is withdrawing part of the capital as well as the profits being earned by the business. The capital account does not become overdrawn. The interest payable on the increased overdraft is an allowable deduction.

Example 2

Maddie owns a flat in central London, which was bought ten years ago for £125,000. There is a mortgage of £80,000 on the property. Maddie has been offered a job in Holland and is moving there to live and work, but intends to come back to the UK at some time. Maddie decides to keep the flat and rent it out while away. The London flat now has a market value of £375,000.

The opening balance sheet of the rental business shows:

-	**Amount**	-	**Amount**
Mortgage	£80,000	Property at market value	£375,000
Capital account	£295,000	-	-

Maddie renegotiates the mortgage on the flat to convert it to a buy to let mortgage and borrows a further £125,000. They withdraws the £125,000, which is then used to buy a flat in Rotterdam.

The balance sheet at the end of Year 1 shows:

-	-	**Amount**	**Amount**	-
Mortgage	-	-	£205,000	Property at market value
Capital account	B/F	£295,000	-	-

-	-	**Amount**	**Amount**	-
-	Less Drawings	£125,000	-	-
-	C/F	-	£170,000	-

Although Maddie has withdrawn capital from the business, the interest on the mortgage loan is allowable in full because it is funding the transfer of the property to the business at its open market value at the time the business started. The capital account is not overdrawn.

Example 3

Blake has taken over the family business, which is a small firm manufacturing plastic dinosaur toys. It does reasonably well, making a profit of £45,000 a year. The factory unit was built 20 years ago at a cost of £150,000 and stands near the centre of town. Blake has it revalued and negotiates with the bank to increase the business loan facility, secured on the factory. Part of the drawings of £150,000 are used to buy a holiday home in Spain.

-	-	**Amount**	**Amount**	-
Bank loan	-	-	£200,000	Factory premises
Revaluation reserve	-	-	£150,000	Plant & machine
Trade creditors	-	-	£20,000	-
-	-	-	-	Trade debtors
Capital account	B/F	£55,000	-	-

-	-	Amount	Amount	-
-	Profit for year	£45,000	-	-
-	Drawings	£150,000	-	-
-	C/F	-	£ (50,000)	-

Although the bank loan is secured on the factory and is shown as a trading liability in the accounts, part of the money has been used to fund drawings in excess of the capital and the profits. The fact that part of the drawings were used to buy a property in Spain does not determine the tax treatment. An interest restriction is due because the drawings were in excess of the profits of the trade available for drawing and the capital Blake had in the business.

A tax computation adjustment is required to add back interest on £40,000.

This figure is arrived at as follows. The effect of depreciation on plant and machinery needs to be taken into account, as does the funding provided by trade creditors. So the assets which have been funded by the bank loan are the factory cost £150,000, plant and machinery cost £20,000, and trade debtors of £10,000, less the trade creditors of £20,000 = £160,000. As the total loan is £200,000 and only £160,000 has been used for the purposes of the trade then interest on £40,000 of the loan is not allowable as a trading deduction.

Looking at it another way Blake's capital account is overdrawn by £50,000. But the accumulated profits have been reduced by depreciation of £10,000, which is a non-cash item. The drawings exceeded the accumulated profits of the trade (before taking into account depreciation) by £40,000, which must have been funded by the increase in the bank loan.

In this example the revaluation of the premises is shown as a separate revaluation reserve on the balance sheet. But it could have been treated within the capital account, to increase the proprietor’s capital account balance. This would not affect the restriction of the loan interest. The capital account would be in credit by £100,000, but this would have to be adjusted by reference to depreciation and revaluation.

There is more guidance on overdrawn capital accounts at BIM45705 (https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim45705) onwards.

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