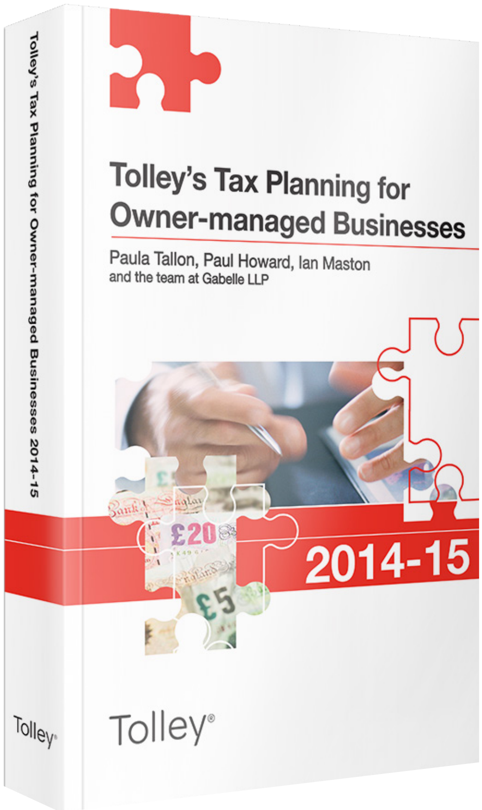
TOLLEY'S TAX PLANNING FOR OWNER -MANAGED BUSINESSES 2014-15

Chapter 2 extract
Loans to Participators



Close companies

Close companies and tax consequences

[2.1]

Owner-managed companies will typically be close companies. A close company is one which is 'under the control (a) of 5 or fewer participators, or (b) of participators who are directors' (CTA 2010, s 439(2)). A company not resident in the UK can never be a close company.

There are a number of consequences of close company status:

- Loans to shareholders are subject to a 25% tax charge payable by the company (CTA 2010, s 455). This is in addition to the benefit in kind charge where the shareholder is an employee or a director.
- Benefits provided to non-working shareholders are treated as distributions (CTA 2010, s 1064).
- A close investment holding company is subject to tax at the full rate (CTA 2010, s 18).

In addition to the potential tax charges, there are some advantages to the shareholders of a close company:

- Interest relief is available where the shareholder has borrowed money to acquire shares in the close company or where the money has been lent to the close company for the purposes of its business (ITA 2007, s 392).

Participator

[2.2]

A participator is defined in CTA 2010, s 454 as 'a person having a share or an interest in the capital or income of the company'. It specifically includes:

- a person who holds or is entitled to acquire share capital or voting rights in the company;
- a person who is a loan creditor of the company;
- any person who holds or is entitled to acquire a right to receive or participate in distributions of the company or in any amounts payable by the company (in cash or kind) to loan creditors by way of premium on redemption; and
- any person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for their benefit.

Loan creditor

[2.3]

A loan creditor (CTA 2010, s 453) in relation to a company is a creditor in respect of a debt incurred by the company:

- for any money borrowed or capital assets acquired by the company;
- for any right to receive income created in favour of the company;
- for consideration the value of which to the company was (at the time when the debt was incurred) substantially less than the amount of the debt; and
- for any redeemable loan capital issued by the company.

Normal trade creditors are not loan creditors. Neither are hire purchase creditors, as there would be no debt for capital assets acquired by the company. With a hire purchase, the assets remain in the ownership of the hire company until the final instalment is paid, therefore it is not a debt for the ownership of assets; the payments are more akin to a rent.

Director

[2.4]

A director (CTA 2010, s 452) is any person occupying the position of a director by whatever name it is called. It also includes a person in accordance with whose instructions the directors are accustomed to act and a manager of the company who owns more than 20% of the share capital. In calculating the amount of share capital owned, the rights of associates are taken into account, as well as any shares owned indirectly.

Associate

[2.5]

Associate (CTA 2010, s 448), in relation to a participator, includes:

- any relative — where relative means husband, wife or civil partner, parent or remoter forebear, child or remoter issue or brother or sister. Separated spouses are associated until they divorce. Half-brothers and sisters are associated, but step-brothers and sisters are not;
- business partner — where this means partners in a partnership or members in an LLP;
- the trustees of any settlement in relation to which the participator (or any relative living or dead) is or was a settlor;
- the trustees of a settlement or the personal representatives if the participator has an interest in any shares or obligations of the company which are the subject of a trust or are part of the estate of a deceased person; and
- if the participator is a company, any other company interested in those shares or obligations.

Settlements can lead to problems in looking at associates. For example, if a trust has 100 shares and the participator is one of five beneficiaries, are 20 shares counted or are 100 shares counted? The legislation directs that the rights of the trustee are counted, so this would cover the rights of the 100 shares. This can seem unfair if the beneficiaries are not associates. The same applies in looking at share rights under an estate.

In the case of *R v IRC, ex p Newfields Developments Ltd* [2001] UKHL 27, [2001] 4 All ER 400, Lord Hoffmann said:

> 'The effect of these cumulative definitions is that for the purpose of deciding whether a person "shall be taken to have control of a company" under s [450], it may be necessary to attribute to him the rights and powers of persons over whom he may in real life have little or no power or control. Plainly the intention of the legislature was to spread the net very wide.'

Loans to shareholders

[2.6]

Where a close company otherwise than in the ordinary course of a business carried on by it makes a loan to an individual who is a participator or an associate of a participator, there is a 25% tax charge. This amount is paid over to HMRC where the loan is still outstanding nine months after the end of the accounting period. When the loan is repaid, the tax is returned to the company nine months following the accounting period in which the loan is repaid.

EXCEPTIONS TO THE CHARGE

[2.7]

There are a number of exceptions to the charge to tax under s 455 and these are set out in s 456. They include:

- loans in the ordinary course of the company's business of money lending;
- money owed for goods or services supplied by the company in the ordinary course of its business under normal credit terms provided to external third party customers as long as the credit period does not exceed six months; and
- certain small loans made to full time employees or directors of the company.

Trade credit

The date that the debt is incurred is when the goods are delivered or the services are provided and credit runs from that time until payment (CTM 61535).

Exception for small loans

A s 455 charge will not arise where a loan is made to a full-time director or employee of the close company assuming:

- the aggregate of the loans by the close company and its associated companies to that borrower do not exceed £15,000; and
- the borrower (together with his associates) does not have a material interest in the close company or any of its associated companies.

<u>The £15,000 threshold</u>

The following guidance and example in CTM 61540 are useful in determining whether the £15,000 threshold is breached:

> 'When deciding whether the limit of an individual employee has been reached, do not take loans to the spouse into account.
>
> Where both husband and wife are directors or employees, they will each be entitled to a separate limit of £15,000.
>
> **Cumulative loans total more than £15,000**
>
> Where a participator who does not have a material interest in the company receives small loans over several periods, the aggregate may eventually exceed the £15,000 limit for exemption. For example, a director may receive £5,000 in AP1, £2,000 in AP2 and then £10,000 in AP3. In isolation each of these would qualify for the exemption, but in aggregate he has received £17,000. The two earlier amounts continue to meet the requirements for the exemption and therefore remain outside the charge.
>
> However, we do not just charge the excess of the aggregate over £15,000 (£2,000) under CTA10/S455 in AP3. Rather the full amount of the £10,000 loan in AP3 does not meet condition in S456 (4)). The S455 charge in AP3 is therefore on the full £10,000 loan in that period.'

<u>Material interest</u>

A material interest for these purposes (s 457) is more than 5% of the ordinary share capital or an entitlement to more than 5% of the assets of the company on a winding up or under any other circumstances.

If the borrower did not have a material interest at the time the loan was made, but later acquires one, the company is treated as making the loan at the time he acquires the material interest (s 456(6)).

Loans to acquire shares

[2.8]

Where the loan is made before the individual becomes a participator – for example, if a loan is made to an individual and that individual subsequently becomes a shareholder – there is no charge under CTA 2010, s 455 provided there is no link between the loan and the individual becoming a shareholder. HMRC have been known to attack situations where a loan is made for the purposes of acquiring the shares. Some commentators would argue that there are no grounds for a s 455 charge in this situation as there is no legal entitlement to sue for the shares at the date the loan is made. HMRC's Company Taxation Manual at 60120 states:

> 'The words "entitled to acquire" and "entitled to secure" introduce the concept of a potential participator. So, for example, a person is a participator if, by means of a contractual right or by rights arising under a trust deed, they can:
>
> - require a shareholder to transfer shares to that person; or
> - secure the issue to that person of unissued capital of the company; or
> - secure that if the company makes a distribution or if a loan is redeemed by the company at a premium, that person has a share in the distribution or the premium.
>
> Similarly, a person is a participator if by means of a contractual right or some other arrangement he can secure that income or assets of the company will be applied directly or indirectly for his benefit.
>
> References to being "entitled to acquire" or "entitled to secure" apply where a person is presently entitled to acquire, etc., at a future date and where a person will at a future date be entitled to acquire, etc.'

If loans are made for the purpose of acquiring the shares, care needs to be taken with the documentation. It would be better, where appropriate, to have partly paid shares. Although partly paid shares give rise to a notional loan which is a benefit in kind, they do not give rise to a loan which can be taxed under CTA 2010, s 455. Further details on partly paid shares are contained in Chapter 10.

The FTT decision in *RKW Limited* (2014) TC03289 considered the position where a new investor (JG) subscribed for shares in a company, with an agreement to pay for the shares in four instalments.

The shareholder/directors of RKW Limited ('RKW'), a close company, identified a potential new investor, (JG). JG was not connected with any of the shareholders or directors in RKW.

RKW, its existing shareholders and JG entered into an agreement under which the existing shares were designated as A ordinary shares and JG subscribed for B ordinary shares, all issued on the signing of the agreement, giving JG voting control over the taxpayer.

The terms on which JG would subscribe for a new class of B Ordinary Shares in RKW were recorded in an agreement between JG and the existing shareholders in RKW. The agreement stated that:

> '20) JG shall subscribe for the "B" Ordinary shares for cash at par and shall pay for that subscription in the manner and on the dates set out in Schedule 4. The "B" Ordinary Shares shall be fully unconditionally and irrevocably issued in consideration of the agreement of payments herein and as detailed herein within Schedule 4. ... The share to JG shall irrevocably be issued to JG immediately upon the signing hereof. ... the parties ... agree that JG is hereby acquiring a full 51% majority ownership of the Company ... '.

The subscription price referred to above (which was £2,170,102) was payable in four annual instalments with the first instalment becoming due one year following the signing of the agreement. Interest was payable on unpaid subscription amounts.

JG did not pay the subscription monies provided for in the agreement.

RKW recorded the subscription amounts in its balance sheet under the heading 'Debtors'. Under current accounting practices the inclusion of unpaid share capital within 'Debtors' is optional and in many cases it is not included until the amounts have been called up.

HMRC asserted that the arrangement was within loans to participators rules and that JG was a participator in RKW and the subscription amounts constituted a debt. HMRC first assessed RKW to tax under TA 1988, s 419 on the basis that JG was a participator in the taxpayer who 'incurred a debt' of £2,170,102 to the taxpayer on entering into the agreement.

HMRC later assessed RKW to tax on a different basis; that a liability to tax under s 419 in respect of a debt of £500,000 arose on 20 November 2001 when the liability to pay the first instalment payment in accordance with the agreement was not satisfied.

RKW appealed against the assessments on the grounds explained below.

The FTT found that the subscription amounts did not constitute a debt for the purposes of ICTA 1988, s 419 (now CTA 2010, s 455). The FTT agreed that even if JG had incurred a debt, he was not a participator when he incurred the debt. JG only incurred a liability on signing the shareholders' agreement, which was the very action that made him a participator in RKW.

Consequently the appeal was allowed.

In another case, *Aspect Capital Ltd* UKUT (2014) 0081 the position where employees acquired shares with the benefit of a facility agreement was considered.

Aspect Capital Limited ('AC') operated an 'employee participation scheme' (EBT), designed to give shares to 'selected key employees'. Employees wishing to participate in the incentive arrangement entered into a share acquisition agreement with AC.

Under the acquisition agreement, employees agreed to pay AC, the EBT trustee, or any other person as AC directed, the purchase price for the shares.

Employees entered into an arrangement known as a 'facility' to enable them to acquire shares without having to pay for them immediately. Once the acquisition agreement and the facility agreement had been executed, AC paid the facility amount to the EBT trustee, less the stamp duty due, and the trustee transferred legal title of the shares to the relevant employees.

HMRC asserted that the employees became indebted to the company at the time they entered into the facility agreement and acquired the shares and that the transaction was caught by the loans to participators rules.

AC argued that it had not made loans to the employees and cited the case of *Potts' Executors v CIR*, 32 TC 211 to support this.

The First-tier tribunal dismissed the appeal on the following grounds:

- The facility was both a loan to employees and a debt under ICTA 88, s 419(2) (now CTA 2010, s 455) and not an advance.

- The definition of a 'loan' includes 'a payment by A to C at B's request where there is a legal obligation on B to reimburse A the amount paid'.

- The obligation for the employee to repay the facility amount arose at the time AC transferred money to the EBT, although the time the amount must be repaid was deferred until a contingency event.

The Upper tribunal agreed concluding:

- 'Although there was a possibility that the amount would not be repaid, or would not be repaid in full, that did not reduce the amount of the debt owed at the time it was created.

- Tax was chargeable on the full amount of the facility amount made available to the employee.'

So why did these cases, both involving shares and outstanding amounts, have a different income?

The existence and use of the facility agreement is a key factor. The use of a facility agreement involved an extraction of profits, assets or value from the company, the exact mischief that s 455 is designed to counter.

Also RKW involved a subscription for new shares whereas in Aspect the employees purchased existing shares in the company.

Further details on employee shares and using partly paid shares are contained in Chapter 10.

Loans to relevant persons

[2.9]

Until 20 March 2013 a charge under s 455 applied where a loan or advance was made to a relevant person. A relevant person was defined in s 455(1) to include individuals and companies receiving a loan or advance in a fiduciary or representative capacity. In recent years, companies have used trust and partnerships in structures to avoid a s 455 charge, while the participators still had the benefit or use of the funds.

If, for example, prior to 20 March 2013, a close company made a loan to a partnership in which all the partners were individuals and one of the partners is a participator (or an associate of a participator), HMRC would argue that there was a loan to a participator so that s 455(1) applied. However, where the partners were not all individuals, the loan was not caught as it was not to a relevant person, i.e. individuals.

Section 455(1) has been extended by Finance Act 2013 and now applies to:

- trustees of a settlement where one or more of the trustees or beneficiaries (actual or potential) is a participator or an associate of a participator in the company; and
- an LLP or other partnership where one or more of the individuals is a participator in the company or an associate of the participator.

Example

Mr A is a 100% shareholder of B Ltd. Mr A and B Ltd set up an LLP where they are partners. If B Ltd makes a loan to the LLP the loan is chargeable under s 455.

Until the FA 2013 changes there was doubt about the application of s 455 to loans to a partnership whose members include the company itself. Where genuine partnership arrangements existed it was difficult for HMRC to contend that the loan was caught under s 455. However, if the loan was drawn out by the individual from the partnership, HMRC applied s 459 so that a charge arose. This would be the case if the participator partner is also overdrawn on his own account with the partnership.

Where the loan is repaid relief will be available if the loan is repaid before the due and payable date (nine months and one day from the end of the accounting period). The usual exceptions also apply so that loans which are made in the ordinary course of a money lending business are not caught.

Generally, where a loan is made by the company to another company, even if this is controlled by one or more of the participators, no section 455 charge will arise unless the loan is in some way used to make a payment to participators. This is provided for in CTA 2010, s 459:

> 'Where, arrangements are made by any person otherwise than in the ordinary course of a business and:
>
> a close company makes a loan or advance which, apart from this subsection, does not otherwise give rise to a charge to tax under section 455, and

a person other than the close company makes a payment or transfers property to, or releases or satisfies (in whole or in part) a liability of, an individual who is a participator in the company or an associate of a participator, s 459 will ensure a tax charge arises.'

Supposing the company makes a loan to an employee to buy shares from existing shareholders, s 455 will apply where the employee is already a shareholder, but if not s 459 would apply following the acquisition of the shares. The same problem can arise in a situation where there is a takeover by a new company and part of the funding is from a loan from the target company. This loan finds its way out to the shareholders as a payment so the company gets caught with a loan to participator charge.

Where a number of loans have been made to an individual and these are subsequently repaid, the directors can decide which debt the repayment should be set against. In the absence of a specific allocation, the rule in *Clayton's case* (1816) 1 Mer 572 applies so that the repayment is set against the earliest debt first.

Book entries can be used to make a loan repayment. These will be effective so long as the entries reflect the underlying reality of a transaction and they are properly recorded in the company's books (CTM 61600).

Where a loan is written off or waived, the amount becomes taxable on the shareholder as a dividend under ITTOIA 2005, s 415. Where the participator is also an employee (or a relative of an employee), the charge under s 415 has priority over the charge on the employee under ITEPA 2003, s 188 (HMRC Company Taxation Manual at 61630). Therefore, any amount chargeable under ITTOIA 2005, s 415 is not also charged as income from employment. However, the amount released or written off will attract Class 1 NIC if it is remuneration or profit derived from an employment (SSCBA 1992, s 3(1)).

CTA 2009, s 321A prevents a corporation tax deduction for the write off. As s 464 gives priority to the loan relationship provisions, it is unlikely that relief would be available under the 'wholly and exclusively' rules.

Repayment of loans

[2.10]

FA 2013 introduced a new s 464C to address the issue of 'bed and breakfasting'. This introduces two restrictions to relief under s 458 and s 464B, which prevent a repayment of tax arising under s 455 or s 464A, where loans effectively remain outstanding beyond the nine month window.

The first is where a company has made a loan of more than £5,000 on which a s 455 charge arises (a 'chargeable payment'), repayments totalling more than £5,000 are made, and within a 30 day period new loans of more than £5,000 are made, the repayment is ignored (in whole or in part) for s 455 purposes.

Relief is denied on the lower of the amount repaid, and the amount of the new chargeable payment made by the company. The restriction does not apply where repayment is chargeable to income tax, eg. *Aspect Capital Ltd* UKUT (2014) 0081 where a dividend is used to repay the loan.

For example, assume that a company has previously made a loan of £10,000 to one of its shareholders, and it has paid tax under s 455 of £2,500 in accordance with its CTSA return for the year to 31 March 2012. On 31 March 2014 the shareholder repays the loan, the aim being to claim a refund of the s 455 tax on 31 December 2014. However, on 15 April 2014 the company makes a new loan of £8,000. In this case, the repayment will be restricted to £2,000 x 25% = £500.

The second restriction applies where:

- immediately before a repayment is made, £15,000 or more is owed to a close company in respect of one or more chargeable payments made by the company to a person;
- at any time after the repayment is made, the close company makes a chargeable payment ('the new payment') to the person or an associate of the person; and

- at the time of the repayment any person intended that the new payment would be made, or arrangements had been made for the new payment to be made.

Relief is denied on the lower of the amount repaid and the amount redrawn. As with the 30 day rule, the restriction does not apply where a dividend, for example, is used to repay the loan.

There is no time limit on this restriction and will catch any situation where there was an intention to draw money out of the company otherwise than by way of bonus or dividend. The objective is clearly to enforce compliance, especially bearing in mind the introduction of RTI at the same time, which requires a greater level of attention to PAYE obligations.

This restriction is intended to catch situations where a proprietor uses company money by maintaining an overdrawn loan account on which income tax is never paid.

Where dividends are used to clear loan accounts the timing is crucial. There are two types of dividend: an interim and a final. The interim dividend is usually paid by the directors. The directors need to be authorised to do this in the articles of association. It is treated as paid when the cash goes to the shareholders. Where it is credited against a loan account, it is treated as paid at the time it is credited to the loan account. This cannot be done retrospectively, so if a loan account is cleared with an interim dividend, this needs to be credited before nine months have elapsed since the year end to avoid a loan to participator charge. A final dividend is recommended by the directors, but it is approved by the shareholders at the annual general meeting. As it is approved by the shareholders, it is actually the shareholders who declare the dividend. It becomes due and payable at that point or such later date as may be agreed.

Arrangements conferring benefit on a participator

[2.11]

FA 2013 has introduced ss 464A to 464B to catch other extractions of value by participators, such as capital contributions made by the company to an LLP where the participators are also members of the LLP.

For s 464A to apply there are two main conditions which must be present.

- A tax avoidance purpose. The main purpose or one of the main purposes is to avoid or reduce or obtain relief from a charge under s 455 or to obtain a tax advantage for the participator or associate.
- Conferral of a benefit on a participator or an associate of a participator.

Using the facts of the example above where an individual, Mr A, who is a participator in B Ltd, forms an LLP with B Ltd. The profits of the LLP are allocated to B Ltd. B Ltd leaves the profits undrawn on capital account in the LLP. Mr A would draw on the capital amounts without triggering a s 455 charge.

Section 464A imposes a tax charge if during an accounting period a close company is party to arrangements which confer a benefit (directly or indirectly) on an individual who is a participator (or an associate) in the close company. ‘Arrangements’ is defined in s 464A(7) and includes ‘any arrangements, scheme or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions’.

Suppose that instead of making a loan in the example above B Ltd contributes capital to the LLP. There would be no charge under s 455, but if Mr A overdraws on his account with the LLP a charge will now arise under the new s 464A.

Section 464A is widely drafted and, in the absence of clearance from HMRC to the contrary, it would be prudent to assume that it will apply to the transactions of this nature.

Distributions

[2.12]

Where a company is close, the meaning of distribution is extended by CTA 2010, s 1064 to include certain benefits provided to participators. The benefits include:

- living or other accommodation;
- entertainment;
- domestic or other services; and
- other benefits or facilities of whatever nature to the extent that the expense is not made good to the company by the participator or an associate.

For corporation tax purposes, no deduction is available for the expenses incurred in providing the benefits to the participators which are included in the extended meaning of distributions.

The amount of the distribution is calculated using the rules for calculating the value of a benefit for employees. The provision of these benefits by reason of a person's employment will not normally be treated as a distribution.

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