Back to basics

# Tax on loans to participators

## Speed read

**CTA 2010 s 455 broadly subjects loans by a company to participators and associated persons to tax at an income tax rate, but chargeable on the company as if it were corporation tax. The tax is eligible for repayment once the loan is repaid. The charge extends to indirect loans and advantages as a result of a loan. There are exceptions for de minimis amounts where the individual works full time for the company and has no material interest in it. Points to watch in practice include payment dates, repayments, waivers, cheap loans, multiple accounts and management buyouts.**

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### Why tax a loan from a company?

To the amateur and the enthusiastic trainee, it sounds like a great tax wheeze: build up wealth in your own company (taxed at 19%, currently), and lend it to yourself, indefinitely, thereby putting off the day when you subject yourself to income tax on the extraction.

HMRC has long been aware of this ploy, and it introduced anti-avoidance legislation in as early as 1965. Indeed, the name an adviser instinctively attaches to the resulting law ('s 286 charge', 's 419 charge', or 's 455 charge') is a reliable indicator of the adviser's age.

The solution (currently found at CTA 2010 s 455) is broadly to treat such loans as subject to tax at an income tax rate, but chargeable on the company as if it were corporation tax. The tax is eligible for repayment once the loan itself is repaid because, in many cases, this is the time at which income subject to income tax is extracted from the company. Consequently, from the perspective of HMRC, it is effectively a deposit on the income tax it will receive; in short, if the company has sufficient funds to lend the amount to a participator, it must also 'lend' some to HMRC. To the individual concerned, it removes the incentive to delay the extraction.

### Situations where the rules can apply

The tax can apply when a close company makes a loan or advance to:

- a person;
- an associate of that person; or
- a partnership of which the person (or an associate) is a partner, where that person is an individual (or company acting in a fiduciary or representative capacity) and a participator of the close company.

CTA 2010 s 459 also extends the scope of the charge to include indirect loans, i.e. arrangements where a close company advances monies to a third party without a s 455 charge arising, and as a result a participator receives a payment or property, or has a debt satisfied.

The tax can also apply under CTA 2010 s 464A when a participator receives an advantage as a result of a loan; for example, where a company makes a loan to another company, with the intention of benefiting a participator. In a group situation, this may be the case with an upstream loan from a subsidiary to a parent to provide cash to buy out the shareholders.

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### The tax charge and administration

The liability is 32.5% of the amount of the loan or advance that remains outstanding at the year end. Where repayments are made, or the loan released, in the nine months following the year end, the liability is reduced by 32.5% of the repayments. Effectively, therefore, the tax is 32.5% of the loans or advances made in the year that are not repaid within nine months of the year end.

The liability to tax is declared on the company tax return's supplementary pages CT600A, in respect of relevant loans or advances at the end of the period, together with any repayments against the loan within the following nine months that would reduce the liability.

It is paid in accordance with the company's usual corporation tax timetable, either at the normal due date or by instalments.

### Exceptions

The tax does not apply if the company is in the business of lending money and makes the advance on this basis. Nor does it apply if the balance arises as a result of a sale of its own goods, providing repayment terms are similar to those for other customers, and the balance does not remain outstanding for over six months.

There is also an exception for directors and employees of the company or associated companies where:

(a) the loan or advance is £15,000 or less;
(b) the individual works full time for the company or associated companies; and
(c) the individual does not have a material interest in the company.

### Definitions

- A *close company* is a company controlled by five or fewer individuals, or by its directors. The holdings of a shareholder's associates are deemed to be held by them, for the purpose of determining this.
- A *loan or advance* includes a straightforward loan, and an advance (for example, early payment of amounts owed, such as salary) as one would expect, but also instances where the company pays for personal items of the individual. For example, an individual might buy personal goods on a company credit card.
- A *participator* is a shareholder of the company or a loan creditor of the company (with the exception of those lending in the ordinary course of their business). The definition is extended to include those who will have such rights in the future.
- An *associate* includes a relative who is a linear ancestor or descendant (grandparent, parent, child, grandchild etc.), sibling or spouse. Associate also includes trusts settled by the participator or a relative of the participator.

A material interest is an interest which gives control over more than 5% of the share capital or assets on a winding up. For these purposes, the rights of an individual's associates are deemed to be held by the individual.

All of the conditions need to be met for the exception to apply. However, do not be tempted to skip the initial analysis of a director's loan without first considering the main rule. For example, a full-time director with no shareholding or other interest in the company and a loan of £20,000 would not qualify for the exception ((b) and (c) would be met, but (a) would not); however, as the director has no interest in the company, he is not a participator and hence not within the general rule.

## Points to watch in practice

### Multiple accounts

Where a participator has multiple accounts with the company, the fact that some of those accounts may be at a credit and others at a debit is ignored when calculating the s 455 position. The s 455 charge is calculated only by reference to those accounts showing monies owed by the participator. To be considered a repayment of the loan, a formal offset of debit and credit balances is required.

### Cheap or non-interest loans

Where the participator is also an employee or officer of the company, normal beneficial interest rules for employment-related loans apply, under which a benefit in kind could accrue where interest is not paid at a rate at least equal to the beneficial rate.

If the borrower is not themselves an employee or officer but is related to a person who is, then such a benefit would instead accrue to the relative.

Strictly, benefits received by a shareholder may be a distribution in law. For tax purposes, CTA 2010 s 1064 taxes benefits received by a shareholder of a close company where the benefit has not otherwise been subject to employment tax. The benefit is calculated on the same basis as for employment purposes and taxed as a distribution to the shareholder. Hence an investor who is not an employee or a relative of an employee could be treated as receiving a distribution if they pay no (or little) interest.

### Repayments

Loans are not always repaid before another advance is made. How, then, should repayments be allocated to determine whether an amount due at the year end is still outstanding nine months later? Taking out new loans to repay old loans would seem to be a way around these rules. Also, it would be tempting to recommend repaying the loan the day before the nine month cut off, only to take the loan out again immediately after the cut off.

To prevent this, CTA 2010 s 464C counters such 'bed and breakfasting', and this can be broadly categorised into two rules:

- the 30 day rule; and
- the arrangements rule.

The 30 day rule broadly mandates that within any 30-day period, repayments should be matched with new loans in that period. This means that, to the extent that repayments exceed new loans in the relevant period, or where repayments are separated from new loans by over 30 days, they may be eligible for offset against the balance that would otherwise give rise to the s 455 tax. A de minimis of £5,000 in respect of the repayment and the loan balance applies.

The arrangements rule may apply where the outstanding loan exceeds £15,000 and repayments exceed £5,000. Where there are arrangements for further loans to be made in order to facilitate the repayment, the repayments will be offset against the new loans first.

However, s 464C will not apply where a loan is settled by the payment of a bonus or declaration of a dividend by the company. In that event, it would be expected that a UK-resident participator would suffer income tax on receipt of the funds for settlement. The exception will only apply where the company on which the s 455 charge arises is the same company paying the taxable income. This could be a problem where, for example, a loan is advanced by a subsidiary, but settled by a dividend from a parent company (i.e. leaving the balance owed by the parent to the subsidiary company).

It may be possible to borrow from another company (outside a group) to repay an outstanding s 455 loan. However, care is required with cashless transactions, as they may not legally constitute a repayment.

Outside of these specific rules on matching repayments with loans, the legislation is silent. In accordance with general case law, earlier loans should be settled before later loans, unless a repayment is made with an express intention of repaying a particular advance.

### Waivers

A company may choose to release a loan rather than require repayment. Whether or not such a release is considered a distribution in law, ITTOIA 2005 s 415 determines that it constitutes a taxable distribution to the borrower, regardless of whether they are personally a shareholder of the company.

Where the borrower is also a director or employee of the company, strictly the loan is also an employment-related loan, such that a waiver would ordinarily be taxable as employment income. However, by virtue of ITEPA 2003 s 189, the distribution treatment takes priority, such that the release will not be treated as employment income.

No such exception applies for NICs purposes; hence, a release of a s 455 debt to a director or employee remains subject to class 1 NICs.

### Date of payment/waiver

For non-cash repayments, the date of settlement should be the date it is recorded in the company's books and records against the loan. Even cash repayments must be allocated to a loan account, unless repayment documents specify which debt is repaid. In particular, note that if a company declares an interim dividend retrospectively for a year to repay a shareholder loan, both the payment of the dividend and the loan repayment will occur on the date that the relevant journal entries are made.

There can, therefore, be a considerable delay from repayment of a loan to refund of the associated s 455 tax

### Claiming the repayment

Where the tax is payable, claims for refund of the tax can only be made and be due for repayment nine months after the year end in which the repayment was made. There can, therefore, be a considerable delay from repayment of a loan to refund of the associated s 455 tax. For example, a loan made in the year ended 31 December 2019 and still outstanding on 31 December 2020 could be repaid 1 January 2021. As the repayment is made during the year ended 31 December 2021, the refund of s 455 tax would be due from 1 October 2022: 21 months after the repayment.

As mentioned above, where a repayment is matched against a loan or advance within nine months of the year end after which it was advanced, the repayment is noted on the corporation tax return's CT600A, and reduces the amount of s 455 tax payable.

However, where a repayment or waiver is made between nine and twelve months after the year end, the repayment claim can still be made on the CT600A for the period during which the loan was advanced (before the end of the 12 month period). The repayment itself will then usually be made nine months after the filing date for that return, i.e. nine months after the end of the year during which the loan was repaid or waived.

Otherwise, in order to make the claim, form L2P should be completed and submitted to HMRC. This replaces a free-format correspondence process that existed previously. Such a claim should be made within four years of the end of the year in which the repayment was made.

While the repayment of the tax ought not to be strictly made until nine months after the year of repayment, HMRC may adopt a practical approach where a company is in liquidation, in order to facilitate its winding up – typically only making the repayment after all other tax liabilities of the company have been settled.

### New company management buyouts (NewCo MBOs)

Often in a NewCo MBO the payment of the cash consideration to the exiting shareholder is funded from cash reserves of the acquired company (OldCo). Usually this is through the declaration of a dividend by OldCo, but occasionally there may be insufficient reserves or other factors that prevent a dividend from being paid immediately, so monies are lent to NewCo to settle its debt.

Section 459 is likely to apply in such circumstances, as there is an arrangement under which OldCo is lending money, as a result of which a participator is receiving a payment. The exiting shareholders will remain participators of OldCo as loan creditors of its holding company.

## Recent developments

Perhaps the most significant change to the legislation in recent history was in 2013, when various changes were enacted to curtail a number of perceived abuses, including:

- Extending the scope to include loans to partnerships: along with the introduction of the mixed partnership rules the following year, a number of common corporate/partnership structures became ineffective.
- Section 464A was introduced for arrangements conferring benefits on participators.
- Section 464C introduced the bed and breakfasting rules for repayments.

A couple of tax cases are also worth mentioning.

In *Esprit Logistics Management Ltd and others v HMRC* [2018] UKFTT 287, the priority given to ITTOIA 2005 s 415 to tax the waiver of a loan as a dividend was overridden to instead tax the release as employment income subject to PAYE and NICs. Essentially, the courts concluded that the releases of directors' loan accounts were in reward for service, and construed that the waiver represented the declaration of a bonus that was used to repay the loan. This case highlights the importance of understanding the true motive for releasing debt – notwithstanding that directors themselves have a fiduciary duty to protect company assets and therefore need to consider such action carefully.

In *R (on the application of Cartref Care Home Ltd and others) v HMRC* [2020] STC 516, the courts concluded that the imposition of the s 455 charge did not breach human rights.

## Conclusion

The loan to participator provisions continue to be a key tax protection for the exchequer. They ensure that HMRC collects tax, even if just temporarily, in circumstances when the shareholder is otherwise personally able to enjoy company funds. ■

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