DIXON WILSON
CHARTERED ACCOUNTANTS

Loans from Close Companies - Trouble Ahead?

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INTRODUCTION

HM Revenue and Customs announced on 20 March 2013 a consultation on reforming the rules governing the taxation of close company loans to their participators. In addition, Finance Act 2013 introduced specific legislation to counteract three loopholes that have been commonly used by company directors since the inception of the rules in 1965.

BACKGROUND

A close company is one controlled by five or fewer 'participators' (akin to shareholders) together with their associates, or by any number of directors who are participators.

A participator is an individual that has an interest in the capital or income of a company, usually via a shareholding. However, an individual can also have an interest via any form of security that provides this benefit. Most "owner managed businesses" that are incorporated will be close companies.

Where a loan or advance of money is made by a close company to a participator, a tax charge equating to 25% of the loan applies to the company if the loan is still outstanding nine months after the company's accounting year end. The tax charged is repayable when the loan is repaid to the company. There is an exception to the rules if the money is lent or the debt is incurred in the normal course of business. Furthermore, where the borrower, together with their associates, owns

less than 5% of the company, works full time for the company, and the outstanding loan does not exceed £15,000, then the loan will be exempt from the tax charge.

CHANGES INTRODUCED BY FINANCE ACT 2013

The three changes that have been introduced and will take effect for companies with year-ends on or after 20 March 2013 are as follows:

LOANS TO PARTNERSHIPS (INCLUDING LIMITED LIABILITY PARTNERSHIPS) AND TRUSTS

To correct the wording in the legislation so that where loans are made to partnerships or trusts where partners or beneficiaries/ trustees are also participators in the close company, a tax charge will now arise in these instances. This will treat partnerships and trusts as if they were individuals when these circumstances arise.

VALUE EXTRACTION NOT JUST LOANS OR ADVANCES

Finance Act 2013 introduced an anti-avoidance provision to counteract arrangements where participators, either directly or indirectly, extract value from the company without the company being subject to the tax charge or the amount otherwise being chargeable as the individual's income. This provision will not apply if the value is returned to the company, with no consideration being given for that return of value, within nine months of the company's accounting year end.

'BED AND BREAKFASTING'

The main change counters the ability for a participator to repay a loan within nine months of the accounting year end, only to redraw some or all of the loan shortly afterwards, thus avoiding the tax charge on the company.

If loan repayments of more than £5,000 are made (which would have given rise to a tax charge on the company) and within a 30 day period any amount is redrawn, then the net repayment is ignored for this purpose.

In addition, even if the "30 day rule" does not apply, relief will be denied if at the time of the repayment of a loan or advance, there are arrangements, plans or intentions to redraw loans, advancements or benefits in the future. This will only apply where there are amounts outstanding of at least £15,000 at the time of the repayment.

Please note if the loan is repaid via taxable income such as a bonus or a dividend then these provisions do not apply.

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NEW CONSULTATION

The consultation is to consider if the current rules achieve the objectives set out below:

1. Effective deterrent to employment income avoidance. The close company loans to participator rules are anti-avoidance provisions. Loans to participators amounted to £1 billion last year, which gives an indication that the current system is not working to deter such avoidance;

2. Is the charge itself robust against avoidance? The current rate of 25% is lower than the tax and national insurance which would be suffered if taken as employment income. Close companies and their participators could still take advantage of the lower rate on longer term loans;

3. Does not inhibit genuine commercial transactions. The current rules allow for short term loans to be taken in normal commercial circumstances and for them to be later declared as income. Any changes will need to ensure that these sorts of transactions are not affected;

4. Fairness. Whether the difference between the rate of the tax charge and tax due on employment income is fair within the tax system; and

5. Simplification. Whether any changes can help simplify the reporting of loans, tax charges and save costs of the administrative burden of the current regime.

HMRC have suggested four potential options for consideration:

1. Maintain the current regime

Make no changes and keep the legislation as it is, subject to the amendments made in Finance Act 2013.

2. Retain the current rules but increase the tax charge on the company

To keep the same legislation in place but simply increase the tax charge on the company from 25% to, say, 40%. This would help to deter companies making long term loans to its participators and bring the charge more in to line with that of income tax, thus negating the tax benefit of providing loans in place of employment income.

3. Permanent tax charge on the company on amounts outstanding at the company's year end

Rather than having a tax charge that is repayable once the loan or benefit is repaid to the company, a graduated tax would be levied which would increase each year the loan is outstanding.

The non repayable tax would deter participators taking out loans in the first place or having these in place for long periods of time. This would also aid simplification of the system as repayments of the tax charge would no longer have to be accounted for by companies or HM Revenue and Customs.

4. Permanent tax on the average amount of loans outstanding during the year

This proposal is for a permanent tax charge on a graduated scale, increasing each year the loan or benefit is outstanding but calculated on the average amount outstanding during the year.

This would affect participators who use their companies as a "personal bank account" throughout the year and draw dividends or salary prior to the end of the 9 month window following the end of the accounting period in order to avoid the tax charge on the company. This would create additional administration for the company as they would have to keep detailed records of loan account movements. In addition, potential tax charges could arise where loans are repaid shortly after the year end, which may deter the use of loans in bona fide circumstances.

SUMMARY

The new changes and, more importantly, the consultation into future changes will be unwelcome news for many owner managed businesses where, historically, there has not always been a clear divide between personal money and company money. Until now it has been possible to manage the tax position by ensuring overdrawn shareholder and directors' loan balances were properly repaid shortly after the year end, usually by way of a bonus or dividend.

The new proposals, if introduced, would require companies to have much tighter control over the balances they have with their directors and shareholders. The tax cost of getting this wrong could be punitive.

It is too early to tell what the outcome of the consultation will be. For now, however, it is clear that clients should be taking advice and reviewing how they might be impacted, both by the newly introduced rules and the rules now being proposed.

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