TAXREP 23/14 (ICAEW REPRESENTATION 58/14)

REFORM OF CLOSE COMPANIES LOANS TO PARTICIPATORS

ICAEW welcomes the opportunity to reply to a request from HMRC for possible adjustments to the scheme for close company loans to participators in a letter dated 5 March 2014.

This response of 24 April 2014 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

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ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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MAJOR POINTS

Introduction

1. In 2013, we responded to the Government's consultation on the reform of close company loans to participators, TAXREP 53/13. The subsequent announcement that there would be no fundamental change to the regime, was welcome. However, we understood that some areas would be given further consideration.

2. In a letter from HMRC dated 5 March 2014, we were invited to comment on areas of concern involving loans to partnerships, including limited liability partnerships, loans to charities, and loans to employee benefit trusts. This is our response to that letter.

3. All statutory references, unless otherwise stated, are to the Corporation Tax Act 2010 (CTA 2010).

Need for a commercial purpose exemption

4. There is an urgent need for the introduction into s455, of some form of' 'commercial purpose' exemption. This is particularly important now that its ambit has been extended by the Finance Act 2013 provisions.

5. Example

A Ltd lent money to a 'connected' LLP which is engaged in property development. The money was to be used to fund a genuine property development (via an LLP), but the loan would have been caught by s455 (even though there were no funds passing to the partners at that stage, the loan was simply a form of 'internal' funding). If the property development been through a 'connected' company, there would be no s455 charge.

6. This does not seem logical or fair. There are a number of other circumstances where the current rules potentially impact on commercial transactions for example under s459 in management buy outs (see CTM61670) and loans to an employee benefit trust (EBT) which holds shares in the close company

Management buy outs

7. During an MBO, the passing up of funds on loan account to the acquiring 'Newco' will invariably be caught by s459, where the monies are used to satisfy the seller's sale consideration by Newco. This is an entirely legitimate method of financing MBOs (ie, using the target's company's funds), which does not now fall within the financial assistance rules. The problem is that this potential tax charge is often missed by many advisers and is therefore a trap.

8. We understand that there is some evidence that HMRC lost an old Special Commissioners case on this point in the late 1980s (before we had case reporting), but of course that may have depended on the precise facts. Some also say that HMRC do not vigorously seek to enforce this piece of legislation, but there is an obvious dilemma here since the charge is subject to self-assessment. The potential application of s459 to MBOs in particular therefore needs urgent consideration.

Employee benefit trusts

9. It is a common commercial practice for an EBT to take out a loan from the company to facilitate employee share ownership. These are examples of genuine commercial transactions which are not intended for the purpose of tax avoidance. An exemption to the s455 tax charge should be considered for this type of genuine commercial loan.

10. Government policy is to promote employee ownership and using EBTs is one way to achieve this. It seems anomalous for a s455 charge to apply to something where there is a clear desire to encourage indirect employee ownership.

The timing of s455 tax repayments

11. The timing of s455 tax repayment can be unfair and is often much later than when the corporation tax is paid.

12. For example, a close company with a year end of 31 December 2013 made a loan to a participator on 1 June 2013. The tax due under s455 is payable on 1 October 2014. If the loan was subsequently repaid on 2 October 2014, then the s455 tax would not be repaid until 1 October 2015 (ie nine months after the year end of 31 December 2014 in which the loan was repaid). This is almost a year after the loan was repaid. If instead, the loan had been repaid on 30 September 2014, there would have been no such delay in the relief (see s458(4) and (5)).

13. As illustrated in the example above, the time lag between when the s455 tax on the loan is paid and when it is repaid can be significant.

14. This is a particular problem for companies closing down, where the need to recover s455 tax can cause considerable delays to the process.

Unpaid share capital

15. The First-tier Tribunal has determined that the close company loans to participators rules in section 419 of the Income and Corporation Taxes Act 1988 did not apply to deferred payment of the consideration for a share subscription, RKW Ltd v HMRC [2014] UKFTT 151 (TC).

16. This case concerned unpaid share capital. The judge prevented HMRC from collecting s455 tax and made some comments about the need to interpret the legislation purposively. Unpaid (not uncalled) share capital is a common practical issue.

17. The following summarises the FTT’s view:

18. In this case, shares issued by a company to a new investor were to be paid for in instalments. HMRC sought to tax the company on the amounts owed to it by the investor under s455. The First-tier Tribunal took a purposive approach and found in favour of the taxpayer. Section 455 is designed to impose a charge to tax where profits, assets or value are extracted from a company without a charge to tax. There was no such extraction in this case and so s455 should not apply: ‘it [what is now s455] is not designed to penalise, discourage or distort investment in close companies and should not be construed so as to apply to the making of an investment’.

Corporate partner’s undrawn profits

19. We welcome the revised guidance on the new rules introduced in Finance Act 2013, however, we still have a number of concerns set out below.

20. Notwithstanding the new rules concerning corporate partners being introduced in Finance Bill 2014, we consider that the issue of a corporate partner’s undrawn profits is still unclear.

21. Section 455 provisions apply if a close company makes a *loan or advances money* to ….

(c) a limited liability partnership or other partnership one or more of the partners in which is an individual who is

(i) a participator in the company, or

(ii) an associate of an individual who is such a participator.

22. The guidance clearly refers to loans, the definition of which we assume is as set out is s456(2) where the person incurs a debt to a close company with the exclusion for trade debts provided the terms of credit are less than 6 months.

23. The guidance helpfully points out in CTM 61520:

‘For loans made on or after 20 March 2013, the fact that such loans are chargeable is now made explicit by the legislation; equally loans to LLPs will be chargeable regardless of whether one or more of the partners/members is a company……’

‘There has been no change to the meanings of ‘loan’, ‘advance’ or debt. HMRC accept that, on the facts in most cases, capital contributions and undrawn partnership profits do not amount to loans or advances within the meaning of the legislation.’

24. Notwithstanding this, as the two interpretations are somewhat at odds with each other and there is no apparent basis for such assurance, we should be grateful if you could confirm in the legislation that undrawn profits, whether left on current account or on capital account, are not caught by the new provisions.

25. It is our view that these are not caught by reference to your published guidance and the fact that s464A has been inserted specifically as a Targeted Anti-Avoidance Provision (TAAR) and is aimed at arrangements as defined where the main motive is avoidance of tax. The main concern seems to the ability for partners to draw on the funds of the close company. The guidance should be clarified to confirm that where no partners account is overdrawn and there are undrawn profits by the close company, s455 does not apply

26. This issue could affect the majority of corporate partnerships as it is highly unlikely that profits are withdrawn in full in common with other members.

27. Another instance that we have come across is where sometimes short term funding is advanced to members of an LLP by the LLP although the current and capital account accounts are not overdrawn.

Loans to non shareholder partners

28. We note that HMRC regard partners as associated by being members of the same partnership/LLP. If there is no avoidance motive, we should be grateful if you could confirm that s455 would not apply if a loan to a non shareholder partner is made by the LLP.

Administration

29. Deminimis loans: we consider that a de minimis exemption, perhaps in line with the benefit in kind provisions, would reduce the administrative burden of dealing with small amounts.

30. New form: we note that a new non-statutory form is being designed for repayment claims, but feel that amending the CT600A should also be possible and would save having a new extra form to deal with as well.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)