



TAXREP 53/13

(ICAEW REP 141/13)

ICAEW TAX REPRESENTATION

REFORM OF CLOSE COMPANY LOANS TO PARTICIPATORS RULES

Comments submitted on 2 October 2013 by ICAEW Tax Faculty in response to the consultation Reform of Close Company Loans to Participators Rules issued by HM Revenue & Customs on 9 July 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation, Reform of Close Company Loans to Participators Rules published by HM Revenue & Customs on 9 July 2013.
2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

4. ICAEW is a professional membership organisation, supporting over 140,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.
5. Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.
6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

KEY POINT SUMMARY

7. We do not believe that the current regime needs changing and favour option one.
8. The Finance Act 2013 has tackled perceived tax avoidance activities which were of concern to the Government. No further change should be considered until the effects of this legislation can be noted and analysed.
9. The view of our members is that loans are rarely made for avoidance purposes. The general commercial practice is for owner-managers to draw amounts from 'their' company, and then when the accounts are later prepared, personal-related items are debited to their loan accounts. These practices generally give rise to an overdrawn loan account, which is then often cleared by an appropriate bonus or dividend. The current system deals reasonably well with this situation.
10. The administrative burden of the 'repayment' procedure for the s455 tax would be eased if repayments could be dealt with as part of the CT 600 return procedure.
11. We suggest that the s455 regime would be improved by the addition of a worthwhile 'commercial' purpose exemption. The absence of such an exemption often inhibits genuine commercial funding transactions, eg, a loan by a close company to a 'related' property development LLP.

GENERAL COMMENTS

12. It is rare that we have almost total agreement from our diverse committees and volunteers regarding our response to a tax consultation. However in this case virtually all who commented, say that HMRC should retain the current system since it is well understood and

fulfils its policy objective. Those who responded otherwise felt the system had out-lived its purpose and s455 tax should be abolished completely.

13. We understand the Government's concern to ensure that value extracted from a close company should be taxed. In our view, existing legislation does this through the s455, CTA 2010 charge or through the benefits in kind rules. We note that, as the consultation document confirms, earlier this year 'Finance Act 2013 closed three perceived weaknesses in the legislation'. In the view of our members, it is important to allow time for the impact of these new rules to take effect before further changes are considered.
14. We note that a further purpose of this consultation is to 'explore the potential for updating the regime to make it fairer, less administratively burdensome and more robust against avoidance'.
15. The view of our members is that loans are rarely made for avoidance purposes. The general commercial practice is for owner-managers to draw amounts from 'their' company, and then when the accounts are later prepared, personal-related items are debited to their loan accounts. These practices generally give rise to an overdrawn loan account, which is then often cleared by an appropriate bonus or dividend.
16. The administrative burden of the 'repayment' procedure for the s455 tax would be easier to administer if it could be dealt with as part of the CT 600 return procedure.

Commercial purpose exemption

17. We suggest that the s455 regime would be improved by the addition of a worthwhile 'commercial' purpose exemption. The absence of such an exemption often inhibits genuine commercial funding transactions, eg, a loan by a close company to a 'related' property development LLP.
18. We understand that it may be difficult to construct such an exemption to cover 'business' transactions, but we would be happy to work with HMRC to consider how this might be structured.

RESPONSES TO CONSULTATION QUESTIONS

Chapter 1

Q1 Do you agree these are the right primary objectives for rules governing the taxation of loans from close companies to their participators? Please explain your answer.

19. We consider that as a set of broad primary objectives these are good, but implicit in them is the requirement that any legislation is correctly targeted.
20. These objectives are also in line with the Tax Faculty's own Ten Tenets for a Better Tax System, see Appendix 1, and the Treasury Committee's Principles of Tax Policy, published in 2011.

Q2 What, if any, other objectives do you think any reform should seek to address?

21. The existing legislation and the focus of this consultation is the law providing for a deemed distribution treatment. There is also legislation giving a benefit in kind charge related to such loans, and this has not been included in the consultation. The review should be conducted "in the round" and not just on one part of the package. Taking this point further, if looking at avoidance the focus should include the individual and commerciality in particular, and not just the company.

- 22.** The other area which members have identified as needing reform is the mechanism for reclaiming s455 tax which is unnecessarily burdensome.

Chapter 4

Q3 For each of the options, including the current regime as outlined in Chapter 3, please consider the following questions:

- a.** Would the option be an appropriate and effective deterrent to extractions of value by participators from close companies? Please explain your reasoning.

- 23.** We presume this question is concerned with whether each option will deter individuals from the avoidance of personal income tax (paragraph 1.8), rather than deterring extractions of value.
- 24.** The current regime is well understood by professionals and their clients. The Finance Act 2013 changes introduced earlier this year have tightened up the regime considerably.
- 25.** As long as a tax charge results that gives an equivalent charge to other forms of extraction which are taxable, then the close company/participator has substituted one tax for another.
- 26.** Illustration

We consider the present regime gives the right answer if compared with the obvious alternative of a dividend. Comparing the taxes paid to HMRC gives the following:

Suppose a company lends £80,000 to a participator, who has a marginal income tax rate of 40%, and who is also a director or employee of the company. The company's liability under s455, CTA 2010 would be £20,000.

If the loan is 'repaid' by the company declaring a dividend of £80,000, HMRC would repay the £20,000 s455 tax to the company and in its place (if the participator's tax rate on dividends is 32½%) collect £20,000 income tax from the participator, rather more if his marginal rate is 37½%.

Meanwhile, HMRC will have received income tax and Class 1A NIC if the participator is a director or employee, or income tax under s1064, CTA 2010 if he isn't, for each year the loan is outstanding. The annual liability would be £342 Class 1A NIC on the benefit in kind at 4% p.a. less 23% corporation tax relief thereon and, if a director/employee, £1,280 income tax at 40% on the benefit in kind (£1,440 if at 45%). If the participator were neither director nor employee the annual income tax liability would be £800 if liable at 32½%, £978 if at 37½%.

- 27.** Option 2 suggests a higher tax rate, while retaining the existing structure and operation of the regime. In our view, and having regard to the figures in the illustration above, a higher rate of charge is not justified.
- 28.** The permanent charges for loans suggested in options 3 and 4 would be unfair given the benefit in kind charge which already exists.

- b.** Is the option itself robust against avoidance? Please explain your answer.

- 29.** The current system is better understood by the authorities and taxpayers than a new system is likely to be. The current system has been in existence for many years and is thus more likely to be robust against avoidance. Loans made are disclosed in accounts, and iXRBL should be helping HMRC.

c. Does the option inhibit genuine commercial practice? Please provide any real-life examples you have as to why the option could create difficulties.

- 30.** The rules, particularly in relation to parallel partnerships and companies, can result in charges under s455 that hinder commercial financing between the business structures. In such circumstances the benefit in kind charge is a further unfairness as it imposes a permanent tax charge on what might be a temporary commercial financing arrangement. Such arrangements are found frequently where limited liability protection is needed for a particular project eg a partnership which operates in the construction industry may set up a separate limited liability company to handle a specific contract.
- 31.** When a partnership lends funds to another partnership, there is no permanent tax charge of this nature, yet if a company lends commercial finance to a partnership there is. Options 3 and 4 which would introduce permanent charges are likely to be inhibitive and even less fair to temporary finance situations.

d. What do you think presents the fairest option, and why?

- 32.** We consider option 1 is the most appropriate method. We see no compelling case for change. This is fair financially and the least expensive option administratively.

e. How do you think the option affects administrative burdens for business? Would the administrative burdens be proportionate?

- 33.** Option 1, because it is generally widely understood, is likely to be less of a administrative burden than a different system.
- 34.** The apparently simple rate change in option 2 would still impose an additional administrative burden. If the loan is cleared by a dividend payment, it would mean an adjustment is required to the income tax deemed to have been paid, even by basic rate taxpayers.
- 35.** In relation to option 4, few close companies which are often owner managed businesses, keep sophisticated accounting records and therefore it would be extremely difficult and administratively burdensome to arrive accurately at the average amount outstanding during the accounting period in respect of a shareholder (participator) loan account.

f. How could the option better meet the policy objectives or be improved?

- 36.** We are of the opinion that commercial loans between partnerships and companies should be reconsidered: we do not think the rule as presently written operates without potentially damaging results in some cases (see (c) above).

g. Do you think the suggested rates of tax are appropriate? Why (not)?

- 37.** As referred to above we consider any increase in repayable tax would be excessive and would result in an unfair result. We also consider a permanent tax charge to be unjustified, excessive and unfair.

h. Please identify and explain what you consider to be the strengths and weaknesses of the option.

38.

Option	Strengths	Weaknesses
1	Already known and understood Generates a tax charge approximately in line with other extraction methods Requires no new software or systems changes No additional administrative cost	Takes no accounts of commerciality of loans which is bad for business Slow and cumbersome repayment process of s455 tax

2	Builds on a system which is already known and understood May collect too much tax from basic rate taxpayers	Rate changes are confusing to members of the public Changing the rate will require careful record keeping of loans made before and after the rate change. Will bring in more tax to the Exchequer. This was not stated as being one of the objectives of this policy review.
3	A one off permanent charge will not need to be repaid, so reduces administration.	The amount outstanding on a loan account will not be known until the accounts are prepared, which may not be for some time after the year end. This will make it impossible for the participator to clear the loan account in time to avoid the charge. As a director/employee shareholder will also have a benefit in kind tax charge, this will be double taxation and be seen as most unfair.
4	A one off permanent charge will not need to be repaid, so reduces administration.	As for option 3, establishing the amount on which to base the charge may be difficult and as it will be on an average figure, it may not be known until the accounts are prepared, which may not be for some time after the year end. It will be virtually impossible for the participator to clear the loan account to avoid the charge. As a director/employee shareholder will also incur a benefit in kind tax charge, this will be double taxation and be seen as most unfair. Establishing the average amount outstanding during the year is administratively burdensome. We accept that this task is already necessary for the beneficial loans provisions for employees, but this task is likely to be far harder for small family companies where the owners use company funds fairly indistinguishably from their own private funds, which needs to be unravelled by the book-keeper at the year end.

Q4 The options do not form an exhaustive list – we would welcome alternative proposals or suggestions as to how the options or current regime could be improved. Are there any other options that may be more appropriate? In setting out your answer please make reference to the points above.

39. We consider the current system to be the best option because it is well known and relatively fair in costs imposed (subject the issue raised at 3(c) above).

40. Another issue raised by our members in relation to close companies, is the disclosure of loans in the P11D return. This requires calculations for fiscal years and makes it time consuming and hence an additional administrative and costly burden for small companies, which normally only write up books for their company year ends. It would help to either change the P11D disclosure to be based on company year ends for close companies, or to incorporate the interest/tax on interest within the proposed changes for s455 tax, hence removing need for disclosure in P11D return.

Chapter 5

Q5 Are there any other interactions which HMRC should be considering, in particular are there any specific interactions which would render any of the options ineffective or inappropriate?

41. No further comments.

Chapter 6

Q6 Do you think any of the reform options impact upon individuals or households? Please explain your answer.

42. In the case of a permanent charge there is a disproportionate bias against finance from close companies.

Q7 Do you think any of the reform options raise questions about equality? Please explain your answer.

43. As referred to above a permanent charge creates inequality.

Q8 How effective is each of the options at reducing administrative burdens for business? How much time and/or cost would be saved or increased? Please explain your answer.

44. The current system is known which is an advantage administratively. To be able to include claims for repayment in the self assessment CT600 return would be a good administrative simplification.

Q9 What other (positive or negative) impacts do you think each of the reforms may have? Please explain your answer?

45. We do not think the current system needs changing.

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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)