MONEY GO

HMRC has tightened its grip on section 455 loans to owner managers, says Peter Rayney

Section 455, Corporation Tax Act 2010 is a key anti-avoidance weapon for owner-managed companies. Without it, owner managers could easily avoid a tax charge by arranging for 'their' company to lend them funds (as opposed to paying a 'taxable' bonus or dividend).

However, s455 levies a tax charge, equal to 25% of the advance or loan, where a close company makes a loan to a participator (ie shareholder or loan creditor) or their associate (eg spouse, parent, grandparent, child, grandchild, brother or sister). In most cases, the s455 tax liability falls due nine months after the end of the accounting period in which the loan is made. However, if the company pays its tax under the quarterly instalment payment regime, any s455 liability must be factored into its instalment payments. In all cases, the company is able to recover the s455 tax if and to the extent that the loans are repaid.

In the context of owner-managed companies, these loans will invariably be directors' loan accounts (DLAs). Many owner managers tend to use their company as a bank by drawing amounts for their personal spending and other outgoings. There is no problem with that so long as these items are 'debited' to the loan account rather than being charged against profits.

Some owner managers also take 'advances' or 'drawings'. Particular care should be exercised here, especially where such amounts are taken on a regular basis. This is because HMRC may try to tax these 'advances' as earnings under PAYE. It is generally recommended that appropriate loan documentation and board minutes evidence such amounts.

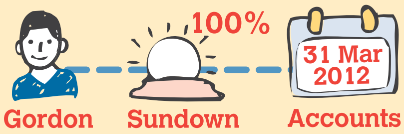
We can be more relaxed now that the Companies Act 2006 permits private companies to make loans to their directors, normally with prior shareholder approval. Since the majority of directors will be the controlling shareholders getting their approval is unlikely to be a problem.

P11D BENEFIT

It should not be forgotten that loans to owner managers would often attract a P11D benefit

EXAMPLE 1 PRE-FA 2013 BED AND BREAKFASTING ARRANGEMENTS WITH DLAs

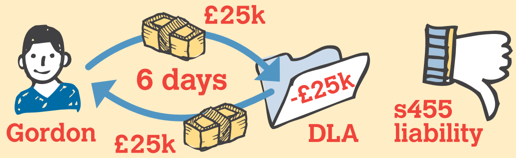
1. Gordon owns the entire share capital of Sundown Ltd, which draws up accounts to 31 Mar each year.



2. During the year ended 31 Mar 2012, Gordon's DLA became overdrawn by £25,000 and he repaid £25,000 on 27 Mar 2012.

3. On 2 Apr 2013, he borrowed the same amount from Sundown, which restored the £25,000 overdrawn balance on his DLA.

4. In this case, the £25,000 repaid to Sundown on 27 Mar 2012 was intended to avoid the s455 tax charge. In HMRC's eyes there had been no real loan repayment, since the same amount was lent again within seven days.



ROUND

25%

Section 455 levies a tax charge, equal to 25% of the advance or loan, where a close company makes a loan to a participator or their associate

under the beneficial loan rules in s175, Income Tax (Earnings and Pensions) Act (ITEPA) 2003. Since 6 April 2014, these rules only apply where the loan exceeds the £10,000 de minimis exemption. In such cases, a taxable benefit arises if the loan is interest-free or below the current official rate of 3.25% (4% before 6 April 2014). Broadly, the taxable amount is computed by applying the 3.25% rate to the average loan outstanding during the tax year. If the company charges interest on the loan, this can be deducted from the owner manager's taxable amount.

GETTING THE S455 TAX BACK

Section 455 is effectively a stand-alone tax charge, which is 'deposited' with HMRC. If the loan or overdrawn DLA is wholly or partly repaid (or released), the appropriate portion of the s455 tax is discharged (ie, effectively cancelled) or refunded. This section initially looks at the amount of the loan outstanding at the company's year-end.

However, provided the loan is repaid within nine months of the year-end, the s455 liability is effectively cancelled and the tax does not have to be paid over. In practice, the company often avoids the payment of an actual s455 tax charge by arranging for owner manager to draw an appropriate bonus or dividend, which is credited to their loan account within the nine-month period.

However, if the loan remains outstanding beyond the nine month due date, HMRC will seek the s455 tax and charge interest from the due date until the tax is paid.

When the loan is subsequently repaid, the repayment of the s455 tax is deferred until nine months after the end of the CTAP in which the loan is repaid or reduced (s458).

BED AND BREAKFASTING OF LOAN ACCOUNTS

In recent years, HMRC has seen the increased use of so-called 'bed and breakfast' techniques to circumvent the s455 tax charge. A typical example of a bed and breakfasting arrangement is illustrated in example 1.

HMRC previously tended to argue that such arrangements were a sham on the grounds 'that viewed realistically no repayment of the loan was made' since it was never intended to be lasting (HMRC Enquiry Manual EM8565). Where HMRC was able to make these arguments stick, it would also seek penalties for careless or deliberately incorrect s455 tax cancellation/repayment claims.

However, the increased use of subtler loan recycling techniques clearly became problematic for HMRC. Furthermore, without making a formal enquiry into the entries on the directors' loan account, many of these arrangements would never be picked up.

FA 2013 COUNTER-RULES

The Finance Act (FA) 2013 introduced measures to negate the purported tax 'efficiency' of using bed and breakfasting techniques. Thus for » 42

loans repaid after 19 March 2013, the legislation prevents the cancellation or repayment of the s455 tax charge in two different situations.

The 30-day repayment restriction

This applies where within a 30-day period:

- a shareholder makes repayments of their s455 loan (of £5,000 or more); and
- in a subsequent accounting period, new loans or advances (of £5,000 or more) are made to the same shareholder or their associate.

This catches the clearest form of bed and breakfasting arrangement. In such cases the s455 tax is only cancelled if and to the extent that the repayments exceed the new loans/advances. In effect, the legislation only recognises the real repayment (since repayments that have been re-lent shortly after the end of the relevant accounting period are 'matched' with each other). An illustration showing the operation of the 30-day rule is shown in example 2.

Importantly, these restrictions do not apply if the loan repayment gives rise to an income tax charge on the relevant shareholder or their associate. Thus, in example 2, if Katy had repaid her loan by drawing a cash dividend of £35,000 from the company on 28 December 2013 – and crediting this to her loan account – the company would avoid the potential s455 tax charge of £8,750 (ie, £35,000 repayment via taxable dividend x 25%).

The legislation strictly provides that the ‘repayment’ itself must give rise to the income tax charge. However, it is hoped that HMRC will adopt a purposive interpretation of this rule. It is reasonable to expect that the ‘income tax charge’ requirement would be met where, for example, a company actually pays a cash dividend to a director, who then uses these monies to repay a loan account.

In practice, HMRC accepts that the crediting of an interim dividend to a loan account represents ‘payment’ at the time the relevant book entry is made, since the amount is then ‘placed unreservedly at the disposal of the directors/shareholders as part of their current accounts with the company. Some company law purists might argue with that analysis, contending that a payment requires a transfer of cash.

The ‘motive test’ rule

This complementary provision operates where a shareholder’s s455 loan is £15,000 or more. It applies where, at the time of the repayment, arrangements have been made for new loans (exceeding £5,000) to replace some or all the amount repaid.

In essence, the motive test matches loan repayments to any new loans that are being ‘planned’ to be made to the shareholder, ie, are there arrangements in place for the company to grant fresh loans or advances? Consequently, to the extent that the loan repayments are matched with such new (future) loans/advances, they will not relieve the relevant s455 liability (see example 3).

As with the 30-day rule, this provision does not apply if the repayment transaction gives rise to a taxable bonus or dividend. Thus if a bonus payment (which is subjected to PAYE/NIC) is used to clear an overdrawn DLA, this credit will give rise to a valid cancellation/repayment of the s455 tax.

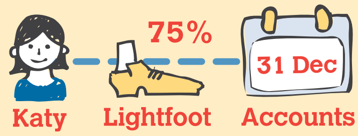
REAL TIME INFORMATION REGIME

At the same time as grappling with the new anti-bed and breakfasting rules for s455, owner managers also have to deal with the real time information (RTI) system for reporting PAYE. This means that they need to be clear about the status of all payments made to them at the time they are made (as opposed to when the company’s accounts are being prepared).

For example, if amounts drawn by a director (and debited to their loan account) are later considered to be a salary/bonus, they will

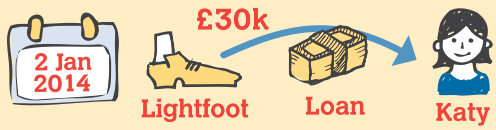
EXAMPLE 2 APPLICATION OF THE 30-DAY RULE

1. Katy is an executive director and a 75% shareholder in Lightfoot Ltd, which makes up accounts on a calendar year basis.

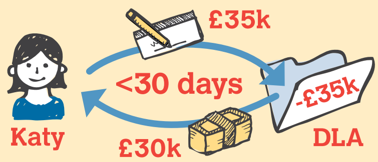


2. The company has incurred some large personal expenses on Katy’s behalf during year ended 31 Dec 2013, so Katy owes the company £35,000 before the week leading up to its 31 Dec 2013 year-end. She repays the £35,000 from personal funds with her cheque clearing the company’s bank account on 28 Dec 2013.

3. On 2 Jan 2014 Katy arranges for the company to advance a new loan of £30,000.



4. The 30-day rule applies here since her repayment and (in a subsequent accounting period) new loan have taken place within 30 days.



This means that the company’s s455 liability will only be reduced as follows:

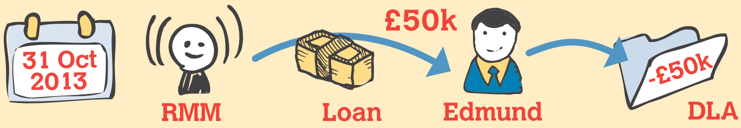
Loan repaid	£35,000
New loan	£(30,000)
Repayment for s455 purposes	£ 5,000

5. Assuming Katy makes no further repayments by 30 Sep 2014, the company’s s455 liability will be £7,500, being 25% x £30,000 (ie £35,000 less £5,000).

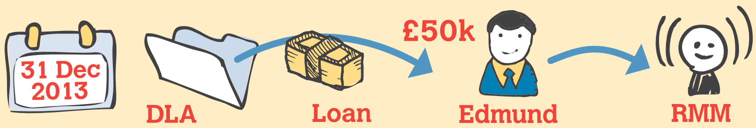
EXAMPLE 3 POTENTIAL HMRC CHALLENGE UNDER THE MOTIVE RULE

1. Edmund holds 100% of the issued share capital of Lightfoot2 Ltd, which makes up accounts to 30 Nov each year.

2. The management accounts show that Edmund owed Lightfoot2 £50,000 at 31 Oct 2013, accumulated over the last 11 months. Edmund wants to clear his loan account to avoid the s455 liability, but as he cannot personally afford to repay it he asks a friend's company, Read My Mind Ltd (RMM), for a short-term loan.



The RMM loan is made on the understanding that Edmund will repay it within two months by taking a new loan from his company.



3. There is a significant risk that HMRC will contend that the arrangement with RMM would be caught by the 'motive test' and may not cancel Lightfoot2's s455 liability on the original £50,000 loan.

2b. On the other hand, Edmund could clear his loan account with a dividend payment of (say) £70,000 on 10 Nov 2013. Since his loan account would have been cleared by a taxable dividend, this would be a valid 'loan repayment' for s455 purposes (see s464C (6)).

3b. Edmund would be liable to pay the income tax on his £70,000 dividend (in 2013/14) by 31 Jan 2015.

not have been reported 'on or before the payment is made' in accordance with the RTI rules, which may lead to penalties being imposed by HMRC.

Under the RTI regime, many owner-managed companies will need to develop greater financial discipline. For example, owner managers might consider an agreed payment plan at the start of the tax year. Assuming the company has sufficient reserves, it would be sensible to bring the loan account in credit by paying an appropriate dividend at the start of the year.

The owner manager can then draw down regular amounts during the year (while keeping their loan account in credit). A one-off salary payment could be made in the last month of the tax year, which would minimise RTI reporting. Companies also need to produce proper contemporaneous evidence to support dividends, salaries and bonuses.

LOANS TO PARTNERSHIPS/LLPs

The FA 2013 also introduced legislation to make it clear that close company loans (made after 19 March 2013) to a partnership or limited liability partnership, in which at least one of the company's shareholders (or their associate) is a partner/member, would be caught by s455. The charge can therefore easily apply where there is no significant overlap between the company's shareholders and the partners or members.

In practice, a company may sometimes make a loan to a 'connected' LLP for a clear commercial purpose. For example, loans are frequently made by a companies to related property development LLPs to fund a new development. Such loans would be subject to a 25% tax charge under s455 (even though no funds were passing to the partners). On the other hand, had the new property development taken place through a 'connected' company, there would be no s455 charge. This seems both discriminatory and inequitable, and representations are being made to HMRC to secure some form of commercial purpose exclusion.

Partners or members often inject funding into the partnership or LLP through their capital accounts, which reflects the nature of their investment or proprietorial interest in the relevant firm. Since partners do not have a right to demand repayment of their capital account, many would strongly argue that this is not a loan or advance within the meaning of s455. Consequently, where a corporate partner or member makes a capital contribution to a partnership or LLP, it should not be subject to a s455 charge.

The FA 2013 also extended the ambit of s455 to catch loans made to the trustees of a settlement in which at least one of the trustees or beneficiaries (actual or potential) is a participator (or an associate of a participator).

The extension of the s455 charge has the potential to catch many unwary owner managers out. The new provisions are widely drawn and their application is likely to be subjective and thus a fertile ground for HMRC enquiries. However, with a little thought and planning, it should be possible to avoid many of the potential problems. For example, it is worth considering bringing director's loan accounts into credit by paying a dividend or 'large' bonus early in the tax year. The account can then be drawn down with no tax repercussions or RTI issues. In other cases, overdrawn loan accounts should be cleared by a dividend or bonus, since this clearly sidesteps the new anti-bed and breakfasting rules.

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