Response from ICAS to the
HMRC Consultation
‘Reform of close company loans to participators rules’

25 September 2013
Reform of close company loans to participators rules

About ICAS

The Institute of Chartered Accountants of Scotland ("ICAS") is the oldest professional body of accountants. We represent around 19,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body.

General introductory points

1. ICAS welcomes the opportunity to comment on the consultation ‘Reform of close company loans to participators rules’ which was issued on 9 July 2013.

2. The application of the section 455 CTA 2010 rules to loans made by close companies to participators can lead to difficulties in practice. As identified in the consultation paper there are situations where directors use company funds without the formality of distinguishing whether the funds are salary, dividend or loan. This is usually due to oversight rather than intent to misappropriate. This has always been the case and happens in many private companies. Consequently, the section 455 rules were put in place and for many years the charge directly mirrored advance corporation tax paid on dividends. This protects the Exchequer and it is effective because, as noted in the consultation paper, £250 million has been paid on loans of £1 billion. Also, the regime has been in place since 1965 without substantive change, which in itself would indicate that the measure is effective.

3. The tax treatment between dividends and section 455 loans leads to a similar overall charge: dividends are paid after corporation tax and subject where appropriate to higher rate income tax; loans are also post corporation tax and are liable to a further 25% tax (the section 455 charge). The key difference in tax take between dividends, loans and salary is national insurance but of course neither loans nor dividends are employment income.

4. There is no evidence to demonstrate that there is a need to change this policy: this charge works effectively to protect the Exchequer, and in most close companies there is no reason why directors should be deterred from having loans. It is also the case that one reason for using loans rather than dividends can often be in situations where distributable reserves are not there, often because of historic losses.

5. Further red tape and regulation should be avoided for owner-managed businesses, which are critical to the success of the economy in difficult times.

6. The tax treatment should mirror the legal nature of the transaction. If funds are a loan and therefore repayable it is appropriate for the section 455 charge to reflect this and be repayable. A simplified repayment process could be introduced, for example, including this on the CT 600J and related IXBRL tagging, rather than requiring a separate claim to HMRC. The rules should not be changed to a permanent tax charge.

7. If there are specific abuses that have not yet been addressed by the changes in FA 2013 then further targeted anti-avoidance provisions are recommended.

8. Clarity around the purpose of the section 455 rules is required but if it has changed and is now to be directed at deterrence, the tax rate change may be the best way to proceed. There are two points of caution, however, because a rise in rates may encourage efforts by taxpayers to avoid this charge if they consider it is unfair. Secondly, transitional measures would be needed for existing loans and tax paid.

9. Careful consideration of the consequences is also required if any changes are proposed because section 455 can often lead to unintended charges on certain corporate transactions (such as reconstructions or recapitalisations) when a private company is involved.
Questions in the consultation paper

1. 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.

ICAS members disagree that the primary purpose of these rules as stated in paragraph 1.7 of the consultation paper is to be a deterrent against companies making loans to participators. The purpose of the rules is to offer the Exchequer protection by placing loans in a similar tax position to dividends, which the current regime does effectively.

It is for the business owner to decide upon the amount and the means of any personal reward and, ideally, this should not be tax driven. In other words, the taxation should be fair and under the present rules there is little difference or unfairness across the taxation of salary, dividends and loans.

- Salary will attract income tax;
- Dividends are paid out after corporation tax and may be subject to further income tax; and
- Loans are paid out after corporation tax and with a further 25% payable as section 455 tax.

The key difference in tax take between dividends, loans and salary is national insurance but of course neither loans nor dividends are employment income.

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

We question whether reform is necessary. The current position operates effectively; it is sustainable having been in place since 1965 and perceived loopholes were addressed in FA 2013. It is well known and relatively simply and there does not seem any need to change this regime.

3. 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.

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

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

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

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

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

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

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

Option one - Maintain the current regime

See response to question 2 above.

Option two - Increase the tax rate but retain the structure and operation of the regime

As noted in the general points above, clarity around the purpose of the section 455 rules is required but if it has changed and is now to be directed at deterrence, the tax rate change may be the best way to proceed given that both tax practitioners and owner-managed businesses are to varying degrees familiar with the rules. There are two points of caution, however, because a rise in rates may encourage efforts by taxpayers to avoid this charge if they consider it is unfair. Secondly, transitional measures would be needed for existing loans and tax paid.
Option three - Replace the current repayable charging system with a lower rated but permanent charge which arises annually on amounts outstanding at the end of each accounting period until the extraction is repaid to the close company

The existing repayable charging system regime reflects the fact that the underlying sum is a loan and repayable. This should not be changed unless there is very strong evidence of tax avoidance that can only be counteracted by placing a permanent tax charge on the temporary source of funds.

In addition this measure would not fit in well with other parts of the tax system. Both employment income and dividends are only liable to tax once when paid – there is no on-going annual charge. Nor is there a need for an annual interest charge which is already provided for in the beneficial loans provisions in section 175, ITEPA 2003.

Option four - Replace the current repayable charging system with a lower rated but permanent charge which arises annually on average amounts outstanding during the accounting period

The comments in relation to option three apply. Furthermore, this option adds the complexity of monitoring on-going loans in order to apply averaging. In practical terms, it would be virtually impossible in a significant number of cases to get the information needed.

4. 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.

See response to question 2 above.

5. 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?

Careful consideration should be given to the interaction with the income tax charge on beneficial loans to make sure that if option 3 or 4 is taken up only one set of charges applies to directors’ loan accounts.

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

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

8. 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.

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

Questions 6 – 9 cover the assessment of impacts. In each impact there would be the burden of changing from an existing system that is generally well known, operating effectively and is simple. The three alternative options all appear more onerous in cost and/or administration.