



# Reform of close company loans to participators rules

## **Summary of Responses** December 2013

# Contents

1	Introduction	3
2	The consultation	4 - 5
3	Responses	6 - 18
4	Next steps	19
5	List of stakeholders consulted	20

**On request this document can be produced in Welsh and alternative formats including large print, audio and Braille formats**

# Introduction

- 1.1 At Budget 2013, the Government announced that it would consult on options to reform the structure and operation of the tax charge on loans from close companies to participators to make the rules fairer and simpler.
- 1.2 On 9 July 2013, the government published the consultation document *Reform of close company loans to participators rules*. The document sought views on whether to reform the rules governing the taxation of close company loans to their participators (and other related arrangements) and on options for such reform. The consultation ran until 2 October 2013.
- 1.3 Following consultation, the Government has decided not to proceed with broad reform of the rules. However, HMRC will continue to engage with interested parties with a view to making more targeted adjustments to the regime.
- 1.4 This document summarises the responses received to the consultation and sets out the Government's response.

## 2. The Consultation

### Purpose of the Consultation

2.1 The Government consulted on options to reform the structure and operation of the tax charge on loans from close companies to participators to make the rules fairer and simpler. The operation of the existing legislation had remained largely unchanged since 1965 until Finance Act 2013 closed three loopholes.

2.2 The objectives for reform set out in the consultation stated that any revised rules should be:

- an effective deterrent to the avoidance of personal income tax at which it is targeted;
- sustainable – itself robust against avoidance; and
- not inhibitive of genuine commercial transactions.

And in line with the broader Government objectives for tax policy of:

- fairness – the tax charge should reflect the advantage gained from taking the loan; and
- simplicity – the regime should be easy and non-burdensome to administer for both businesses and HMRC.

2.3 The consultation document sought views on four potential options for reform, as well as seeking alternative options. The four options presented were:

1. **Maintain the current regime**
2. **Increase the tax rate** but retain the structure and operation of the regime
3. Replace the current repayable charging system with a lower rate which would apply to a **permanent charge which arises annually** on amounts outstanding at the end of each accounting period until the extraction is repaid to the close company
4. Replace the current repayable charging system with a lower rate which would apply to a **permanent charge which arises annually on average amounts outstanding** during the accounting period.

## 3. Responses

- 3.1 The Government received 38 written responses. It also held consultation meetings with stakeholders. Responses were received from accountants, lawyers, representative bodies, businesses and individuals. The overriding message was that the current regime was preferable to any wide reform. The views and reasoning are considered in detail below.

### Primary Objectives

- 3.2 Respondents were asked whether they agreed that these were the right primary objectives for these rules and what, if any, other objectives any reform should seek to address.
- 3.3 There were a variety of views put forward by respondents on the primary objectives for the loans to participators tax charge.
- 3.4 One respondent linked the historical introduction of the regime in 1965 with the now obsolete surtax and Advance Corporation Tax (ACT). They expressed the view that the regime should have been abolished at the same time as surtax or ACT, because they considered that the original reason for the regime no longer existed.

- 3.5 Some respondents stated that the close company loans to participators rules should not be seen as targeting the avoidance of employment income as this should be dealt with through the employment taxes legislation.
- 3.6 Others thought that the charge should be on the participator rather than the company to reflect the link with income tax.
- 3.7 Many highlighted loans as a legitimate tool to facilitate company cash flow and did not feel that the objectives should be focused too heavily on deterring loans themselves. These respondents felt that flexibility of funding is especially important for smaller companies where the movement of funds between the business and the participator is thought about little until the year end reconciliation and is not part of engineered avoidance.
- 3.8 Some respondents acknowledged that the regime has an anti-avoidance function and could prevent avoidance through disguising dividends as loans.
- 3.9 Eight respondents focused on the policy objective that the regime should not inhibit genuine commercial transactions. They expressed the view that the current regime is not sufficiently targeted at avoidance and can

be overly restrictive on commercial funding, especially loans from close companies to certain types of related trusts or LLPs.

- 3.10 A number of respondents commented that the objectives of this consultation are contrary to the current message being promoted by the Department for Business, Innovation and Skills (BIS). BIS included changes in the Companies Act 2006 that made it easier for directors to obtain loans from their companies and which removed some sanctions against what were formerly considered to be improper loans. One respondent presented the concern that taxation rules were being used to deter loans that are not unlawful under the Companies Act.

### **The Government response**

- 3.11 The loans to participators regime was originally introduced to address avoidance of a tax charge on extractions of value from close companies by their participators. At the time, the tax charge being avoided was surtax. Although surtax no longer exists, the regime still plugs a hole in the tax system between forms of extraction which are taxable on the participator (as employment income or distributions) and forms which without the regime would not be; the most common of which are loans. Therefore, the Government considers that the primary objective of the regime is as an anti-avoidance provision.



3.12 However, the Government acknowledges that there may be scope to introduce smaller changes to improve the targeting of the regime and will continue to engage with stakeholders to explore this further.

### Consideration of the options

**For each of the options, respondents were asked to 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 1: maintain the current regime

3.13 The vast majority of respondents preferred retaining the current regime to the other options. Reasons for this included:

- a. the age of the current regime means that it is well understood and therefore simple and cheap for small companies to administer
- b. the Finance Act 2013 changes have provided defences against avoidance and these should be given time to bed down
- c. the current repayment system reflects what the tax is trying to achieve – it is like a deposit or withholding tax (against a taxable dividend or remuneration payment to come later)
- d. the 25 per cent rate is about right for the majority of taxpayers – other than a timing difference, only additional rate taxpayers get an overall effective tax advantage

3.14 However, many of these stakeholders also acknowledged there is room (and in some cases, a need) for less fundamental reforms than those presented in the consultation. These are detailed below.

### The Government response

3.15 The Government has listened to the views of stakeholders and is not intending fundamental reform of the regime or to change its operational structure. HMRC will continue to engage with interested parties to consider in more detail suggestions and concerns put forward during consultation about smaller adjustments to the regime.

## Option 2: Current regime but with a higher rate

3.16 Some respondents acknowledged that there may be a case for imposing a higher rate, particularly if the intention is to focus on creating a deterrent to making loans to participators and target avoidance of income tax. Three respondents preferred a higher rate to any form of permanent annual charge.

3.17 Eight of the nine respondents who commented on the level of the rate stated that 25 per cent seems the appropriate rate for the majority of taxpayers. They considered that it was more important to align the rate closely with the basic and higher rate income tax charge on a dividend (which would therefore apply to the majority of individual participators) than closing the opportunity for additional rate taxpayers to gain a tax advantage. One of those in support of a higher rate suggested about 31 per cent as the appropriate rate as similar to the effective dividend rate for higher rate taxpayers.

### The Government response

3.18 The Government acknowledges that a higher rate could present a large expense and cash flow difficulties for companies and their participators who may not be using the regime for avoidance. The Government acknowledges that the majority of participators are not additional rate taxpayers. However, it also recognises that there is the potential for a tax advantage to be gained through the current regime and therefore intends

to explore further options to target the regime more effectively. This could include a differential/higher rate.

**Option 3: Permanent charge – annual on loans outstanding at the year end; and**

**Option 4: Permanent charge – on average amounts outstanding during the year**

We have examined these 2 responses together as they have a similar structure and they attracted similar views from respondents to the consultation.

3.19 Some respondents acknowledged that a permanent charge could present opportunities for simplicity within the repayment system and, if the rate was sufficiently low, could potentially be cheaper for some companies than the current regime.

3.20 However, the overwhelming majority did not consider this a viable option for a variety of reasons. In particular, some considered it double taxation, and thought it was more appropriate to have a tax that followed the loan – i.e. if the loan is repaid, the tax is repayable.

3.21 Many expressed concern for potentially disproportionate record keeping burdens on smaller companies (especially in relation to Option 4). Any new regime would also impose burdens on companies adjusting to comply with it.

## **The Government response**

3.22 The Government acknowledges the views put forward on these options and does not intend to adopt either of these more radical reform options in light of the concerns raised.

## **Alternative suggestions made by respondents**

**Respondents were advised that the options did not form an exhaustive list and alternative proposals or suggestions would be welcomed.**

3.23 In addition to the four policy options presented in the consultation document, respondents suggested a number of alternative future policy directions for the loans to participators regime, including:

### **a) A commercial exemption**

3.24 Some respondents felt that the current rules inhibited certain commercial behaviours, including for example, certain funding structures. They suggested that it may be possible to devise a test to exclude some loans from the charge.

3.25 No suggestions were provided for how such an exemption might be defined but six respondents raised specific cases where they consider the current rules are overly restrictive. Examples included: funding of certain partnerships and LLPs and certain trusts (including charitable trusts).

3.26 In the examples given, the respondents stressed that avoidance is not the driver behind the making of loans. By having restrictions on funding, there is a distortion of commercial decision making and arguably the regime is not meeting its fairness objective.

### **The Government response**

3.27 HMRC will continue to engage with interested parties to consider in more detail suggestions and concerns put forward during consultation about further adjustments to the regime.

### **b) Simplify the repayment system with automation and the use of the existing Corporation Tax Self Assessment (CTSA) regime**

3.28 Stakeholders questioned whether there was scope for simplifying the repayment process and claiming repayments through the corporation tax return.

### **The Government response**

3.29 HMRC explored the potential for such reform but the current CT600A (supplementary page for loans to participators) and current IT systems cannot be amended in a way which would allow this to be a simple change.

3.30 The Government is therefore exploring options for introducing a non-statutory form which would make it clearer what information is necessary

when making a claim for a repayment to simplify and speed up the repayment process.

**c) Treat loans as distributions**

3.31 Three respondents thought it was more appropriate to impose a tax charge on the individual participators as if they had received a distribution (rather than impose a charge on the company) on the basis that it is the participator getting the tax advantage, not the company.

**The Government response**

3.32 The Government considers that it would not be appropriate to characterise all cases of payments currently caught by the charge as, in substance, distributions.

**d) Introduction of a targeted anti-avoidance rule (TAAR)**

3.33 One respondent suggested that a TAAR could be introduced to strengthen the regime against avoidance but no details were provided as to what this should specifically target or how it may operate.

**The Government response**

3.34 The Government considers that the Finance Act 2013 measures addressed particular areas of avoidance and therefore the introduction of a TAAR would not be necessary. Any future changes made will take account of possible avoidance implications and legislation is frequently reviewed where avoidance is apparent.

**e) HMRC should automatically challenge any situation where there is an overdrawn loan account but no loans to participators charge returned to HMRC.**

3.35 One respondent suggested that HMRC should automatically challenge any situation where there is an overdrawn loan account (i.e. a participator has received a loan and it is still outstanding at the end of the accounting period) but no loans to participators charge made on the return.

### **The Government response**

3.36 The Government's view is that the CTSA mechanism allows the customer to take responsibility for submitting an accurate return. HMRC then takes a risk based approach to the examination of returns, allocating its resource to the areas where the highest levels of risk are identified.

### **Assessment of Impacts**

3.37 The consultation document invited comments on the impacts of potential changes to the regime, specifically:

- Do you think any of the reform options impact upon individuals or households?
- Do you think any of the reform options raise questions about equality?
- How effective is each of the options at reducing administrative burdens for business? How much time and/or cost would be saved or increased?



- What other (positive or negative) impacts do you think each of the reforms may have?

3.38 No respondents commented on the impact upon individuals or households or equality.

3.39 Ten of the respondents stated that any change to the status quo would increase the administrative burden on business. This point was made particularly strongly around the administrative burden that a new permanent charge would impose. There was widespread comment that any changes to such a long established and well understood mechanism would increase the administrative burden on business.

3.40 Five respondents considered there could be an impact on the cash flow of individual directors. This could further impact the economy as these individuals are often investors and creators of wealth for the UK.

### **The Government response**

3.41 The Government is not intending to fundamentally reform the regime or change its operational structure. For this reason it has not made a detailed assessment of potential options for reform. HMRC will continue to engage with interested parties to consider in more detail suggestions

and concerns put forward during consultation about smaller adjustments to the regime. Potential impacts will be considered in these discussions.

## 4. Next steps

- 4.1 Further to the responses to the consultation, the Government does not intend to undertake any fundamental reforms to the regime or to change its operational structure.
- 4.2 HMRC intends to explore options for publishing a non-statutory form to reduce processing delays with claims for repayment.
- 4.3 HMRC will continue to engage with interested parties to consider in more detail suggestions and concerns put forward during consultation with the potential for smaller adjustments to the regime within the existing framework.
- 4.4 HMRC would like to thank all those who have contributed to this consultation process to date.

# Annexe A: List of stakeholders consulted

Armstrong Watson  
Ashursts  
Aspect Capital  
Association of Accounting Technicians  
Baker Tilly  
BDO LLP  
British Venture Capital & Private Equity Association  
Charity Tax Group  
Chartered Accountants Ireland  
Chartered Institute of Taxation  
City of London Law Society  
Deloitte  
DLA Piper LLP  
DWF LLP  
Ernst and Young  
Francis Clark LLP  
Garbutt & Elliott  
Grant Thornton  
Grosvenor  
Harwood Hutton  
ICAEW – SME & PT, Tax Faculty  
Institute of Chartered Accountants of Scotland  
Institute of Directors  
KPMG  
Law Society  
Legal Society of England and Wales  
London Society of Chartered Accountants Taxation Committee  
M&A Partners LLP  
Norton Rose Fulbright  
One E Consulting Limited  
Patricia J Arnold and Co Ltd  
Pethericks and Gillard Ltd  
PWC  
Quoted Companies Alliance  
Share Plan Lawyers  
Wellcome Trust  
Whitefield Tax Limited  
Plus three individuals.