Analysis

Close company loans and participators

Speed read

Close company loans to participators incur a special tax charge. Close company loans *to* participators are entirely distinct from loans *by* participators to close companies. In the former situation the participator is a debtor of the close company. In the latter, the boot is on the other foot, and the close company ends up owing or paying money to the participator. However, the distinction between the two situations would appear sometimes to be missed in practice, causing undesirable and unnecessary confusion.

David Southern QC
Temple Tax Chambers
David Southern QC is a barrister in Temple Tax Chambers. He undertakes all forms of tax litigation and specialises in business taxation, financing, debt restructuring and VAT. Email: david.southernQC@templetax.com; tel: 020 7353 7884.

The rule

If a close company makes a loan or advance to a participator, this will be treated as a concealed distribution for tax purposes. There are two consequences. The close company is liable to a temporary corporation tax charge at 32.5% (CTA 2010 s 455(2)). If the loan is repaid to or released or written off by the company, the tax charge is cancelled (s 458(2)). No loan relationship debit can be claimed (CTA 2009 s 321A). In cases where the loan is released or written off, the participator is treated as having been paid a dividend (ITTOIA 2005 ss 415–417).

'Loan or advance' carries an extended meaning and means any transaction giving rise to a debt owed by the participator to the close company.

This is a familiar rule, going back to FA 1965 s 75. The purpose of the provision was described by the First-tier Tribunal in *RKW Ltd v HMRC* [2014] UKFTT 151 (at para 199) as being to tax concealed distributions: 'The purpose of [s 455] is to impose a charge to tax where profits, assets or value are extracted from a company without a charge to tax (being usually a charge to tax on distribution or dividends).'

The loan by the company to the member is not a distribution because the obligation to repay is treated as new consideration which excludes it from being a distribution (CTA 2010 s 1000(1)B(b)). In *RKW*, HMRC argued unsuccessfully that unpaid subscription money constituted a loan to a participator.

'Participator' includes 'loan creditor', and 'loan creditor' includes a person who holds redeemable debt of a company issued as payment for assets transferred to the company (CTA 2010 s 453).

Indirect loans

This charge to indirect loans by CTA 2010 s 459 (originally introduced by FA 1969, Sch 14, para 2(3)). If the close company lends the money to a third party (X), who lends it on to the participator, X is ignored and the loan or advance is treated as made directly to the participator. The purpose of this provision is straightforward. It was designed to prevent an arrangement whereby the close company deposits 100 with a bank, and the bank then makes a back to back loan of 100 to the participator.

Section 459 reads as follows:

'459 Loan treated as made to participator

'(1) This section applies if under arrangements made by a person (P)—
(a) a close company makes a loan or advance which, apart from this section, does not give rise to a charge to tax under section 455, and
(b) a person other than the close company makes a payment or transfers property to, or releases or satisfies (in whole or in part) a liability of, a relevant person who is a participator in the company or an associate of such a participator.

'(2) Sections 455 to 458 and 464C and 464D apply as if the loan or advance had been made to the relevant person.

'(3) …

'(4) If a company (C) controls another company (D), a participator in C is to be treated for the purposes of this section as being also a participator in D.'

Takeovers

A further extension of this extension has over the years regularly caused uncertainty on business disposals.

The problem is thought to arise with upstream loans. Upstream loans are loans made by:
(i) a subsidiary to a parent; or
(ii) by a vendor to a purchaser.

In case (ii), what happens as a matter of commercial substance is that the vendor is in part paid out of the resources of the acquired business, either at the time of acquisition (if there is cash in the business sold) or on deferred terms (purchase price left outstanding or loan notes issued by purchaser to vendor).

The situation envisaged is that of a post-acquisition loan where, for example:

- Target Co is owned by individuals (Vendors) and is a close company. Target Co holds cash of 1,000. Target Co shares are worth 3,000.
- Acquirer Co wishes to buy the shares in Target Co from Vendors.
- Acquirer Co borrows 1,000 from a bank.
- Acquirer Co buys the shares in Target Co for 3,000, paying Vendors 1,000 cash and loan notes of 2,000.
- Immediately after the acquisition, when Vendors are still on the register of shareholders of Target Co, Target Co lends 1,000 to Acquirer Co (or pays a dividend) to Acquirer Co which then repays the bank.

The concern is this. Target Co (a close company) has made a loan or advance to a third person (Acquirer Co). As a holder of Acquirer Co loan notes, Vendors are participators in Acquirer Co. A participator in a company which controls another company is treated as a participator in that company (CTA 2010 s 450). Vendors are therefore also participators in Target Co at completion. That loan is treated as if made to Vendors by Target Co, and Target Co is liable to corporation tax accordingly.

In other words, s 459 reads: if a close company (Target Co) makes a loan or advance to another person (Acquirer Co) and that other person (Acquirer Co) makes a payment to a person who is a participator in Acquirer Co or Target Co (Vendors), the loan or advance is treated as made to Vendors.

One method of avoiding this charge, it is suggested, is to make the purchase for cash and remove Vendors from the shareholder register of Target Co before the post-acquisition loan is made. If, however, Vendors take loan notes in Acquirer Co, they will remain a participator and the tax charge in Target Co will apply: *Taxation of Companies and Company Reconstructions* (Bramwell) D3.1.12.

HMRC agrees with and develops this analysis. HMRC's *Company Taxation Manual* at CTM61550 provides the following two examples of the application of s 459, where the loan to the participator has simply been routed through a third party.

'**Example 1:** Company D is a close company. Instead of making a loan directly to X, an individual participator, it makes it to an associated company, Company E. Company E then passes the loan to X. The loan by one company to the other is treated as if it had been made direct to X.

'CTA 2010 s 459 was enacted specifically to cover this situation (loan followed by loan) though it also covers other indirect transfers of value.

The analysis, that a purchase of shares relying on Target Co's own cash involves an advance to the vendors of the shares, is mistaken for a number of reasons

'**Example 2:** Company T, a close company, makes a loan to A. A is an individual participator in Company W but not in Company T. Company W, acting in concert with Company T, then makes a loan to D, an individual participator in Company T. Company T and Company W have swapped loans to participators and are treated by [CTA 2010 s 459] as if they had each made loans to their own participators.'

However, the guidance goes on to say that s 459 applies not only to a loan made indirectly to a participator but to payment made indirectly to a participator:

> 'It (s 459) should also be considered in management buy-out situations. In many cases the close company makes a loan to the new owners who then use those funds to pay the outgoing shareholders for their shares … it is exactly the type of arrangement which should be chargeable under s 455. The company's own money is being used to buy out the existing shareholders.'

This issue is often raised as a matter of due diligence on share acquisitions.

Example

Target Co is owned by Mr and Mrs T. Acquirer Co agrees to buy their shares for £8m. Target Co's balance sheet shows cash of £3m. Acquirer Co borrows £2m from a bank. Target Co lends £3m to Acquirer Co. Acquirer Co pays £5m cash to Mr and Mrs T and issues loan notes for the balance of £3m repayable over 5 years to Mr and Mrs T.

Is there a deemed loan of £3m by Target Co to Mr and Mrs T because Target Co has made a deemed distribution of £3m?

The correct interpretation

In my view, this analysis (that a purchase of shares relying on Target Co's own cash involves an advance to the vendors of the shares) is mistaken for a number of reasons.

First, legislation has to be read in context. The loans to participators charge only applies if as a result of the loan or advance the participator becomes the debtor of the close company. It is the fact that the participator is the debtor of the close company which gives rise to the possibility of the repayment of the debt to or release of the debt by the close company.

In a scenario where the participator sells his shares in a company to a third party, he does not become the debtor of the acquirer: he is the creditor. The company cannot release and he cannot pay a debt which he does not owe. If the transaction does not produce a debt owed by an individual which is capable of release or repayment, there is nothing on which the legislation can bite. The two sides of the legislation, deemed distribution by the company and deemed dividend receipt by the participator, must both be capable of application for the legislation to apply. In s 459(1)(b), the words 'makes a payment' can only be referring to a situation in which, as a result of the payment the participator becomes a debtor of the person making it.

A case where the participator supplies something (his shares) in return for payment is exactly the type of arrangement which should *not* be chargeable under CTA 2010 s 455.

Secondly, the purpose of the s 455 charge is to impose a charge to tax on an extraction of money from a company which would not otherwise be chargeable to tax. The vendors, however, will be chargeable to tax (capital gains tax, or possibly income tax) on the purchase price payable to the shareholders by Acquirer Co.

Thirdly, it is irrelevant to the taxation of the transaction how Acquirer Co raises and discharges the purchase price. It is common commercial practice for a vendor to fund his purchaser. The purchaser may borrow money from the vendor, or the vendor may leave part of the purchase money outstanding. That is what happens in the case of a purchase of shares for loan notes issued by the acquirer, because the loan notes are simply a deferred payment of cash.

An issue will only arise if other features of the transaction raise questions as to its commerciality.

In *Barclays Mercantile Business Finance Ltd v Mawson* [2005] STC 1 (*BMBF*):

- a bank bought a gas pipeline from BGE for £91m; there was a transfer of ownership to the bank; and then the bank leased the pipeline back to BGE;
- BGE deposited the £91m with the bank;
- the lease rentals were reduced by the capital allowances which the bank obtained by reason of the purchase of the pipeline; and
- on that basis, the lease rentals paid by BGE matched the deposit receipts received by BGE.

The House of Lords held that the bank had incurred expenditure of £91m. This was the amount which the vendor obtained. The fact that the vendor left the money with or returned the money to the purchaser did not alter that conclusion. The reason why it was held in this case that a circular scheme worked (whereas in other cases such as *Ensign Tankers (Leasing) Ltd v Stokes* [1992] STC 226 and *Tower MCashback v HMRC* [2011] STC 1143 circular arrangements did not work) appears to be that the transaction in *BMBF* was based on the incurred cost of the asset, not projected future revenues. In most share sales to third parties, the commerciality of the transaction will not be in issue.

Fourthly, in *Collins v Addies* [1992] STC746 the novation of a close company loan to a participator (i.e. the substitution of a new debtor) was held to constitute a 'release' of the original loan. This emphasises that the situation the law is concerned with is one where a participator is a debtor of a close company, not the converse.

Transactions in securities

HMRC's concern appears to be that the vendors partially fund the acquisition by Acquirer Co by leaving in the company post-acquisition funds which might have been made over to them pre-acquisition by way of a distribution.

That is a situation which would come more naturally within the transactions in securities rules in ITA 2007 ss 684–713, rather than the loans to participators rules. In general, the conditions for the transactions in securities rules will be satisfied where:

- there is a transaction in securities;
- involving two or more close companies;
- the relevant person receives relevant consideration;
- the taxpayer does not pay income tax on the consideration; and
- the consideration represents profits available for distribution or future receipts of the company.

However, the rules will be excluded by virtue of ITA 2007 s 686, provided that there is a fundamental change of ownership of the close company, i.e. the vendors sell at least 75% of their shares.

Conclusion

In the example given above, there cannot be a loan or advance to Mr and Mrs T. This is because: (i) Mr and Mrs T end up creditors, not debtors; (ii) no value has passed out of T Co, so as to constitute a distribution – the cash is replaced by a loan to its new parent; and (iii) there is nothing colourable in the price paid to Mr and Mrs T.

In my view therefore, people have been frightening themselves with a phantom

The error lies in reading s 459 in isolation from the scheme of the legislation as a whole. The meaning of words is governed by their context. The context is both statutory and factual. Neither the statutory nor the factual context justifies the extension of s 459 in such an unreal way. In my view therefore, people have been frightening themselves with a phantom. ■

Analysis

BT Pension Trustees: possible extension of remedies for breach of EU law

Simon Whitehead
Joseph Hage Aaronson
Simon Whitehead is a founding partner of specialist litigation firm, Joseph Hage Aaronson LLP. He specialises in tax litigation and EU tax law. Email: swhitehead@jha.com; tel: 020 7851 8800.

Cristiana Bulbuc
Joseph Hage Aaronson
Cristiana Bulbuc is an associate at Joseph Hage Aaronson LLP. She holds an LLM in International and European Tax Law, an LLB in European Law and a BA, summa cum laude, in Government and International Politics. Prior to joining JHA, she has worked at PwC Romania and interned at the European Commission DG TAXUD. Email: cbulbuc@jha.com; tel: 020 7851 8830.

Speed read

In *BT Pension Trustees* (Case C-628/15), Advocate General Wathelet challenges the established dichotomy adopted in the characterisation of claims in breach of EU law. He finds a simpler way to address a claim by an exempt taxpayer seeking a credit denied in breach of EU law than the usual distinction between a claim for the repayment of tax and the more restricted claim for damages to compensate for indirect losses. In his view, the primacy of EU law acts to remove the discriminatory provisions pure and simple.

The recent opinion of AG Wathelet in *BT Pension Trustees* (Case C-628/15) provides an interesting and direct answer to the question: what is a taxpayer's remedy for a breach of EU law where it has not paid any tax at all?

The issue arises in the arid context of a tax credit which has not existed for almost 20 years. In very broad summary, until Gordon Brown's famous raid on pension funds in 1997, an exempt taxpayer, such as a pension fund, receiving a dividend from a UK company in which it held a portfolio interest would receive a tax credit (ICTA 88 s 231(3)), which it could redeem in cash by making a claim. However, in the period from 1994, if the UK company paid a dividend which it matched with foreign sourced profits under the foreign dividend income (FID) regime, the availability of a cash credit under s 231(3) was excluded by ICTA s 246C.

The opinion concerns claims by pension funds for such cash credits upon the receipt of FIDs, notwithstanding that restriction. As the advocate general acknowledges, the exclusion of the credit for shareholders on the payment of a FID was established to be a discriminatory aspect of the FID regime over ten years ago.

The advocate general bats away a volley of defences. Chief among them was the argument that as the dividend concerned was paid by a UK resident company to a UK pension fund, there was no cross border movement to engage EU law in the first place. The advocate general was dismissive. The FID regime was specifically targeted at distributions by companies in receipt of foreign sourced income. It has been long established that such a circumstance clearly engages the EU freedoms, even where the recipient is resident in the same state (see *Keller Holding* (Case C-471/04)).