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LOANS TO PARTICIPATORS

It might, on the face of it, be thought tax efficient for an owner-managed company to pay corporation tax on its profits (at a maximum rate of 25%) and then to lend its post-tax profits to its shareholders instead of paying them salary or dividends (which would be subject to income tax in the recipient's hands).

The "loans to participators" rules, however, are designed to make this approach considerably less tax efficient by imposing a charge – sometimes known as a "section 455 charge" – on companies that carry out transactions along these lines.

When the rules apply

The rules can apply where a "close company" makes a loan, or advances money, to:

- an individual "participator" in the company;
- an individual who is an "associate" of such a participator;
- the trustees of any trust in which a participator, or an associate of a participator, is a trustee or beneficiary; or
- a partnership or LLP in which a participator, or an associate of a participator, is a partner.

The rules rely on the following definitions:

- A "close company" is, in broad terms, a UK resident company which is under the control of five or fewer participators, or of any number of participators who are also directors.
- A "participator" is, broadly, any person who has a share or interest in the capital or income of a company. This will chiefly include shareholders, but can also include loan creditors and others with voting rights or rights to distributions from the company. Where one company controls another company, a participator in the first company is treated as a participator in the second company.
- "Associates" include, most significantly, relatives (i.e. spouses, civil partners, siblings, ancestors, and descendants) and business partners.

For the purposes of the rules, a close company is treated as making a loan to a person where that person incurs a debt to the company, or where a debt due to a third-party is assigned to the company.

Tax implications

Company

Where the company makes a loan or advance that is within the rules, and where some or all of this remains outstanding more than nine months after the end of the accounting period in which it was made, an amount will be payable by the company to HMRC as if it were corporation tax. This amount will be calculated as 33.75% (being the higher dividend rate of income tax) of the outstanding amount.

If and when the loan or advance is subsequently repaid by the participator or released by the company, this "section 455 charge" will become repayable to the company. The company must claim the repayment, and it can do so from nine months after the end of the accounting period of repayment or release and before the end of the statutory time limit which is four years from the end of the financial year of repayment or release.

Participator

The loans to participators rules apply specifically to the companies making the loans; a participator in receipt of a loan is not subject to any tax implications directly on the amount of the loan itself.

However, if the loan is interest-free, or if interest is charged at less than the official rate of interest (currently 2.25%), income tax may arise on the "benefit".

In addition, if a loan is released by the company, the amount released will typically be taxed as a dividend in the hands of the participator, at rates of 8.75% for basic rate taxpayers, 33.75% for higher rate taxpayers, and 39.35% for additional rate taxpayers.

Exceptions

There are a number of scenarios where the loans to participators rules provisions do not apply, and these include circumstances where:

- a loan or advance is made in the ordinary course of a business consisting of the lending of money;
- a loan or advance is made to a charitable trust and the funds are applied for charitable purposes;
- a debt is incurred for the supply of goods or services made in the ordinary course of business (provided the credit given does not exceed six months or longer than normally given to customers of the business);
- a loan or advance is made to a director or employee who works full-time for the close company (or an associated company) and who does not have a material interest in the company (broadly 5% of the ordinary share capital), where the total of any loans outstanding do not exceed £15,000.

Other issues

There are various anti-avoidance provisions and complexities within the loans to participators rules. The details of these are outside the scope of this flyer, but the following points should be borne in mind:

- Where a participator has a number of loan accounts with a close company, they may be in a situation where they have both debit and credit balances. In some circumstances it may be appropriate to look at these various balances on a consolidated basis, but in some cases HMRC may argue that they should be treated separately.
- There are certain “bed and breakfasting” anti-avoidance provisions which mean that, where a loan is repaid and a new loan is made, either within 30 days or as part of “arrangements”, the repayment may be treated as relating to the new loan, meaning the old loan balance is regarded as having remained in place for the purposes of the loans to participators rules.
- Where there are arrangements under which a close company makes a loan which does not give rise to a “section 455 charge”, and another person makes a payment to an individual participator in the close company, the loan can be brought within the rules. This can apply, for example, in a management buy-out, where the acquiring company borrows from the target company and then uses the funds to make payments to outgoing shareholders.
- There are complex “disguised remuneration” anti avoidance provisions which can treat loans as employment income under certain circumstances.

How we can help?

The information in this document is intended to provide an outline of the various key tax issues that can arise when close companies make loans to participators. There are various complexities both in the loans to participators rules themselves and in other areas of UK tax legislation that may apply where loans are made. Please do not hesitate to contact us if you require any support or advice in this area.

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