Loans to participators: the devil's in the detail

When is a loan repayment not a loan repayment? Peter Vaines offers some thoughts

To help us pass the time during lockdown, HMRC issued some interesting guidance on the rules relating to repayments where there have been loans to participators within the terms of section 455 CTA 2010. It was not guidance really but an explanation of their view about what represents a repayment.

Everybody knows about the tax implications of loans by a close company to participators and their associates. They are often referred to as loans to directors; and of course directors are often participators – but not always. If a company makes a loan to a participator that is outstanding for more than nine months after the end of the company's accounting period, section 455 CTA 2010 requires the company to make a payment equal to 33.75% of the loan to HMRC.

Where a liability under section 455 has arisen and has been paid by the company, the amount can be recovered from HMRC under section 458 if:

- the loan is repaid to the company, or
- the debt is released or written off.

HMRC point to "an increasing number of cases" where repayments of loans and overdrawn directors' loan accounts are said to have been repaid, but all that has happened is that the debtor balances have been moved around a series of associated companies.

HMRC say (on the authority of Collins v Addies TC 65 190) that "the substitution of a fresh debtor [for the original debtor] does not constitute repayment".

Collins v Addies explains that debtors cannot just transfer liabilities to somebody else; liabilities have to be novated, and a novation is a tripartite contract by the debtor, the existing creditor and a new creditor. The existing debt is released and substituted by another debt owing to the new creditor. The Court held that a release of a loan by way of novation does not represent repayment.

That is all very well – but Collins v Addies expressly held that a novation was a release, so a refund under section 458 would be equally available to the company. (There would of course be a corresponding effect on the participator who would be chargeable to income tax on the amount released by reason of section 415 - 417 ITTOIA 2005.)

In their guidance, HMRC express their concern (with some justification) where repayments are said to have been effected by circular or recycling transaction.

They specifically highlight the position where a shareholder borrows £2 million from company A and just before the repayment deadline he borrows £2 million from company B to repay company A. When the deadline or repayment of company B is approaching, he borrows (again) from company A to clear his debt in company B – and so on every year. On each relevant date (nine months from the end of the accounting period) the loan has been repaid and no section 455 arises.

These arrangements clearly deserve to be challenged because the reality of the situation is clear. Indeed, it is difficult to avoid thinking about Ponzi schemes where money paid out, or lost (creating a hole in the finances), is filled by new investors introducing new money. Accountants have known about this since the dawn of time (which for accountants is 1494) and called it teeming and lading. This is where a cash loss in one customer's account is covered by crediting money received from another customer, and so on. Until the music stops, of course.

However, the reason given by HMRC for challenging such recycling arrangements does not really stand up to scrutiny. They say: "…looking at the legislation as a whole and its purpose there is no repayment and section 455 should apply to the amounts withdrawn from the companies".

Looking at the legislation as whole does not help. The legislation does not provide any grounds for saying that there has been no repayment. What HMRC are really saying is that the legislation does not catch such recycling arrangements – but it jolly well ought to, so we are going to say it does. Not good enough I am afraid – as HMRC are quick to insist when a taxpayer claims a relief which looks entirely justifiable – but it does not quite satisfy the terms of the legislation.
But Collins v Addies is not relevant here; we are not looking at novations or releases and even if we were, it would not make any difference to the analysis. We are looking at whether there really has been a repayment.
Obviously, to be effective, the recycling arrangements must be genuine – otherwise they would fall down on any number of grounds, but it is difficult to say that a loan to company A has not genuinely been repaid if a genuine repayment has been made. And the same with company B.
Rather than relying on inapplicable authority, HMRC might do better seeking to invoke section 464A CTA2010. This is a Targeted Anti Avoidance Rule, which applies where the company or companies are party to tax avoidance arguments where one of the main purposes is to avoid or reduce a charge to tax under section 455. However, that is not a slam dunk by any means.
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