HMRC tax stance complicates recoveries for close companies

Lengthy director negotiations become even more cumbersome when personal tax charges are triggered by section 455 repayments, says **Marcus Rea**

Under company law, unless approved by shareholders (with minor exceptions), loans to directors are unlawful. But assuming one is approved, which is clearly not particularly tricky in owner-managed businesses, a personal tax charge may arise on interest-free or low-interest loans and on any loan waivers. Meanwhile, from the company's tax perspective, where the loan is made to a 'participator' (broadly, a shareholder) in a close company, a tax charge arises on the company itself, which is recoverable in the event that the loan is repaid.

All of this may give IPs some practical issues if any directors' loans exist on the date of an appointment.

Beneficial loans

An income tax benefit-in-kind charge arises where a director or employee obtains a loan or any form of credit from their employer or a company under common control. It also applies to arranging, guaranteeing or in any way facilitating the continuation of an existing loan, just as it does to the making of a loan.

> **"Negotiating the repayment of the loan from a director will be complicated by their knowledge of the personal tax implications for themselves… a director will be taxed at a rate of up to 39.35% on any amount written-off"**

Broadly, if the loan outstanding is greater than £10,000 at any time during a year of assessment, the employee is liable for income tax, and will normally be collected via PAYE. The charge is based on the difference between the interest (if any) the individual pays and interest calculated by reference to an official rate prescribed by the Treasury (for the fiscal year 2023/24 this remains a modest 2.25%).

Loans to participators

However, importantly, where a close company makes a loan to a participator, the company itself is liable for tax (under s455 of the Corporation Tax Act 2010) currently at a rate of up to 33.75% of the loan for the period of accounts in which it is made. Effectively the loan is treated as if it were a dividend distribution to the participator, with the company obliged to withhold tax until the dividend unwinds by the loan being repaid.

Broadly, a participator is a shareholder (or certain other person with an interest) in a close company, generally with a minimum 5% stake, and broadly, a close company is one under the control of five or fewer participators or one which is controlled by its directors.

The tax is due from the company nine months after the end of the relevant accounting period. If the loan itself is repaid after the period end but before the tax is due, then no charge arises.

If the loan is repaid, released or written-off at a later date, the s455 tax is repaid to the company. If only part of the loan is repaid etc, then a pro-rata share of the tax is repaid. According to statute, repayment of the s455 tax is not to be made until nine months after the end of the period in which the loan is repaid.

The company is unlikely to get a tax deduction for any write-off of a director's loan, but this position is worth further consideration based on specific circumstances.

Meanwhile, the individual borrowing director is treated and taxed as receiving a dividend of the amount written off. The dividend treatment takes precedence over treating the write-off as remuneration for a director. However, to avoid a national insurance charge, the write-off would instead need to be a formal deed of release that has been documented by shareholders and agreed to be by reason of the director's status as one of those shareholders.

The issues for an IP

If a loan has been made to a director and is still outstanding at the time of an IP's appointment a handful of issues arise.

If the loan was recently made and no s455 tax has been paid to HMRC, then the tax will rank as an unsecured creditor in the insolvent estate. The scenario where a director is lent money might seem less likely if the appointment of an IP were imminent, but it might arise where, for instance, owner-managers are lent funds from a company throughout a year to be repaid via a dividend distribution post-year-end.

Almost by definition the loan will either be repaid or written-off as part of the insolvency process (or perhaps wither on the vine as a company is finally dissolved) and therefore the s455 tax should be recoverable at some point during the process. We are currently therefore in conversation with HMRC about not including the s455 tax that is theoretically due at the date of appointment in their proof of debt, given that the liability should reverse.

> **An IP will need to weigh up the value of the s455 tax to be refunded against the costs of keeping an insolvency open for a further nine or more months**

As an aside, if the loan was very recently made and any payroll tax on a beneficial loan had not been paid to HMRC, then this would rank as a secondary preferred creditor in the insolvent estate.

If the loan was made some time ago and s455 tax has been paid to HMRC, then that tax is a potential asset of the insolvent estate (again, given that the loan will either be repaid or written-off). However, negotiating the repayment of the loan from a director will be complicated by their knowledge of the personal tax implications for themselves. While still arguably better from their perspective than repaying the debt in full, a director will be taxed at a rate of up to 39.35%[1] on any amount written off and, assuming he or she is properly aware of the implications, is likely to factor this into any negotiation on repayment.

HMRC's position

The R3 Business Tax Working Group thought we had persuaded HMRC that a decision by an IP not to pursue a debt from a director (i.e. as opposed to a write-off or a release) ought to be sufficient to enable any s455 tax to be repaid without triggering a tax charge on the individual.

> **Like in so many other areas, the interaction of insolvency and tax laws doesn't work particularly smoothly**

HMRC's recollection differs. It seems to have accepted this view in terms of the s455 repayment. However, it is also of the view that this can only be as it is equivalent to a write-off and triggers a personal tax charge.

To the working group there is clearly a difference because in the, admittedly unlikely, hypothetical scenario where a director were to win the lottery, the IP might reverse their decision that the debt was irrecoverable and the debt would still be capable of being collected. And the IP, having neither written-off nor released the debt, may enable a director to argue that no income tax is crystallised on a deemed distribution. Whether that argument would remain sustainable for a director if the debt had not been repaid after the ultimate dissolution of the company is clearly debatable.

A claim by the company (via its IP) to recovery of the s455 tax by reason of a write-off or release of the director's debt (or, according to the HMRC view, the decision by the IP not to pursue the debt) apparently automatically triggers a 'nudge' notice being sent to the director from HMRC reminding them that income tax will now be due with the expectation that it be included in their self-assessment return. Therefore, even if

a director was not aware of the personal tax implications during the negotiation on repayment of a debt, they soon will be.

However, as noted, the s455 tax is not repayable by HMRC until nine months after the end of the relevant period of account. It may be possible to foreshorten an accounting period to accelerate repayment, but an IP will need to weigh up the value of the s455 tax to be refunded against the costs of keeping an insolvency open for a further nine or more months. This is especially true given that it is rare for any negotiation about recovery of a loan from directors to be a quick exercise and therefore the insolvency may already have been running for some time and have already been extended.

It is unfortunately not possible to assign the benefit of the s455 tax refund to another party. HMRC's view is that its hands are tied as the refund timeframe is statutorily prescribed. Hence it is sadly not uncommon for the tax refund to be foregone rather than incur the additional costs.

In short, like in so many other areas, the interaction of insolvency and tax laws does not work particularly smoothly. Recovery of directors' loans can be an emotive topic and the tax implications are unlikely to make those conversations easier.

1 For an additional rate taxpayer. 8.75% for a basic rate taxpayer and 33.75% for a higher rate taxpayer.

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