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Via email:

Dear

CTA 2010 s459 – Loans to Participators Charge on Upstream Loans

The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 20,000 members, and extensive volunteer network, in providing our response.

We are contacting you about this statutory provision which members have told us is causing some issues in due diligence on commercial share acquisitions, typically in buyout scenarios where a company lends cash to its parent company, referred to as ‘upstream loans’.

Background

Where a loan to a participator in a close company remains outstanding nine months after the balance sheet date, the company making the loan is required to make a payment to HMRC equivalent to 33.75% of the loan outstanding at the nine-month stage (CTA 2010 s455). This tax liability is well understood and uncontroversial.

However, the s455 charge is extended [by s459] to other situations where there is a loan such as certain tax avoidance scenarios where the loans to participator tax charge would otherwise be avoided perhaps by making the loan to an intermediary, who then loans the money on to the participator. This can cause problems in uncontroversial commercial situations where no tax avoidance is involved, which is the subject of this letter.

Current Legislation

Corporation Tax Act 2010 s459 ‘Loan treated as made to participator’ (also ‘indirect loans to participators’):

(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) But this section does not apply if—

 (a) the arrangements mentioned in subsection (1) are made by P in the ordinary course of a business carried on by P, or
 (b) the total income of the relevant person includes, in respect of the matter mentioned in subsection (1)(b), an amount not less than the loan or advance.

(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.

Effect of legislation on upstream loans

As noted above, as well as operating as effective anti-avoidance, the extended charge under s459 also operates (in our view unfairly) on completely benign upstream loans, which commonly appear in management buy-out scenarios (MBOs). In a typical MBO the management team will form Bid Co which will purchase the shares of Target and issue shares and loan notes as consideration to the vendor shareholders. The purchase will often be financed out of current and future resources of Target and there are two possible approaches:

- Target pays a dividend to Bid Co and Bid Co uses the funds to repay an appropriate part of any debt to the vendor shareholders
- Target lends funds to Bid Co, ie makes an upstream loan, allowing Bid Co to repay some of the debt.

It is this second alternative that causes the problem, as s459 may technically apply to such transactions. It applies where a close company makes a loan or advance which does not give rise to a charge to tax under s455. This condition is clearly satisfied in that a loan from a subsidiary to its parent is not a loan to a 'relevant person', as defined. The second leg is that a person other than the close company (ie the company making the loan) makes a payment to a relevant person who is a participator in the company or an associate of such a participator. S459(4) extends this to payments made to a person who is a participator or an associate of a participator in a company that controls the close company that makes the initial loan.

The legislation treats the combination of upstream loan and any onward payment as an 'indirect' loan from the lending company to a participator, even though the onward payment is not a disguised loan to a participator, it is a payment to redeem the debt incurred when the paying company acquired the Target shares.

It is clear that there is no element of avoidance in these cases. Furthermore, it is almost invariably the case that a pre-transaction clearance will have been obtained from HMRC that the MBO is not intended to avoid income tax (under the transactions in securities rules, Chapter 1, Part 13, ITA 2007). So it makes no sense from a tax policy or anti-avoidance perspective that there is a risk under the loans to participator rules if the pay-out to a vendor shareholder is funded by intra-group debt. In our view this is not a scenario that the loans to participators legislation is meant to

catch because those rules are generally designed to prevent the extraction of profits from companies by way of borrowing, which is simply not happening here.

HMRC

Where s459 could apply, HMRC's guidance [CTM61550[1]] indicates they take a 'strict application' of s459 and states that a s455 charge should arise in the case where intragroup loans have arisen in an MBO situation if there are also payments made to individuals who remain 'participators' in the group. HMRC say '*… it is exactly the type of arrangement which should be chargeable under Section 455. The company's own money is being used to buy out the existing shareholders.*'

This is a slightly strange position as the 'company's own money' might be used to 'buy out the existing shareholders' but depending on the intra-group funding mechanism adopted a s455 charge would either apply (if an upstream loan is made) or would not apply (if the funds were provided by way of intra-group dividend). Indeed, it also seems strange that HMRC consider that a charge might arise where the vendor shareholders retain a shareholding in the post-MBO group, but not when they don't, because they are no longer participators.

It seems to us that HMRC's position has no firm policy basis because it is unclear what the policy rationale is for a tax charge arising when the repayment of debt is funded by an intra-group loan, but not when it is funded by a dividend, and why there is a tax charge on repayment of the debt to the vendor shareholder if a company does not have sufficient distributable reserves to be able to pay a dividend to the parent.

We suggest that some further relieving provisions might help prevent a charge applying where, in our view, it ought not to apply.

Practical issues

Whilst we have not in practice seen HMRC take the point, the risk of s459 applying on a strict technical reading is being raised more frequently on tax due diligence when companies are later sold. This introduces an element of uncertainty of tax treatment into commercial transactions involving share acquisitions. Since the charge under s459 is a matter for self-assessment, taxpayers are generally unclear how to manage the risk or uncertainty. The problem is becoming more prevalent due to the increased potential for funding transactions this way, following the change in company law relating to financial assistance (which often prevented a company funding its own acquisition in this way).

For this reason many of our members now recommend that where possible all existing 'upstream loan' balances should be cleared by dividend rather than intra-group loan (although this may not be possible if there is a lack of distributable reserves in the company). This 'technical solution' can sometimes produce an adverse commercial consequence as individual entity reserves are reduced. And, of course, companies may not always have the cash (or other) resources to repay the loans.

There are relieving provisions where the onward payment is included as income but perhaps curiously no relief if the onward payment has been taxed in another way such as a capital gain (s459(3)(b)).

Conclusion

In summary, we consider that the way that s459 can operate in certain buyout scenarios is not within the policy aims of the legislation in that there is clearly no analogy between a loan to extract funds from a company in the circumstances of s455 and a loan to fund a repayment of a debt incurred for buying shares. In addition, it is causing difficulties in due diligence on share acquisitions and potentially preventing transactions from completing.

[1] https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm61550

We would be interested in your views on the issue we have raised in this letter and in discussing possible options with you, such as an amendment to HMRC's manuals or changes to the legislation. Please note that we intend to publish this letter and HMRC's response on our website.

We look forward to hearing from you.

Yours sincerely

Pete Miller
Chair, Owner Managed Business Technical Committee

The Chartered Institute of Taxation

The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

Our stated objectives for the tax system include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.