Beneficial loans: the importance of getting your timing right

Personal tax **OMB** **Large Corporate**

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The recent case of *England v HMRC* involving a loan to participators highlights the importance of specifying the tax year in which a loan is released.

Key Points

What is the issue?

Mr and Mrs England were directors of a company to which they owed just over £1 million. Under an agreement, they would pay £100,000 to the company and the balance of £900,000 would be formally released.

What does it mean for me?

The payment of £100,000 would be in instalments over a two-year period. If any payment was missed, the full balance (i.e. the £1 million) would become immediately payable. The release of the £900,000 balance was conditional on certain payments being made under the instalment plan agreed.

What can I take away?

The tribunal appears not to have asked when the Englands ceased to be obliged to pay the full £1 million. The case serves as a reminder that the wording of loan releases can impact upon the tax year in which a tax charge arises.

I can remember the first time that I came across an assessment in relation to a loan to a participator. (A participator in relation to a company is broadly a person with shares in (or an interest in the capital or income of) the company.) Having spent the first three years of my professional life in what is now a Big Four firm, I was not aware of such loans existing in practice. However, when I moved to a smaller firm, which specialised in owner-managed businesses, they quickly became a regular feature of my work.

Under what is now the Corporation Tax Act 2010 Part 10 Chapter 3, loans to participators are treated as a form of temporary dividend. Indeed, a part of the rules appears to mirror the old rules concerning companies' former obligation to pay advance corporation tax following the payment of a dividend to shareholders.

Without going into all the complexities of the rules, an outstanding loan balance at the end of an accounting period gives rise to a standalone corporation tax charge broadly equating to the income tax that might have been due had a dividend been paid instead. Upon repayment of the loan, however, that tax charge is reversed. The logic is clearly that the tax consequences of paying a dividend cannot be avoided merely by lending the funds to the shareholder instead. Conversely, when the quasi-dividend is reversed, the tax charge is similarly cancelled.

From the individual shareholder's perspective, the loan will usually be taxed under the beneficial loan rules which apply to employees and directors in respect of the period for which the loan is outstanding.

Additional rules apply if the loan is released. From the company's perspective, a release is treated in the same way as a repayment, because (at the end of the day) the loan is no longer outstanding. As a result, the company should obtain a repayment of the corporation tax charge. However, the individual will then usually be subject to an income charge in respect of the 'benefit' of the loan being set aside. Reflecting the pseudo-dividend nature of the original loan, this tax charge is found in the Income Tax (Trading and Other Income) Act 2005 Part 4, which broadly covers savings and investment income and, in particular, s 415. That s 415 tax charge takes precedence over a similar provision found within the beneficial loan rules so as to avoid a duplication of tax charges.

The s 415 tax charge arises in the tax year in which the loan is released (s 416). Accordingly, the timing of the release will be of fundamental importance.

Although the question of timing will usually not be in any doubt, there will be exceptions. The case of *England v HMRC* [2023] UKFTT 313 (TC) looks at that very question.

The facts of the case

Mr and Mrs England were directors of a company, Alexander Lauren Associates Limited. They were participators of the company, presumably the principal (or only) shareholders. By 28 October 2013, they together owed the company just over £1 million. By that date, the company was already in creditors' voluntary liquidation.

On 28 October 2013, an agreement was reached between the Englands and the liquidator concerning the £1 million owing to the company.

At the heart of the agreement was the fact that the Englands would pay £100,000 to the company and that the balance of £900,000 would be formally released. However, the payment of £100,000 would be in instalments over a two-year period (presumably with certain minimum payments due by specified dates). The final instalment was to be £77,000. If any payment was missed, the full balance (i.e. the £1 million) would become immediately payable. That full balance would be secured by way of a legal charge.

According to the tribunal, clause 4.1 of the agreement suggested that the agreement 'is in full and final settlement of the liability and subject to the payment of the settlement sum is in full and final settlement of all known causes of action that the liquidator may have against the debtors'.

HMRC argued that the £900,000 was released in the 2013/14 tax year, being the year in which the agreement was made. Accordingly, it made discovery assessments in respect of that year for additional income that had not been self-assessed by the taxpayers.

In response, the Englands argued that the release was not effective until such time as the £100,000 had been fully paid in accordance with the agreement (which, implicitly, did not occur until a later tax year).

The Englands' appeal against the discovery assessment was notified to the First-tier Tribunal.

The First-tier Tribunal's decision

The case came before Judge Fionagh Green and Member Jane Shillaker.

The tribunal first asked itself whether ‘the settlement agreement was conditional and dependent on a condition being satisfied or an event occurring’. In summarising the agreement, the tribunal said that ‘the appellants went from owing a debt of £1,009,063 to the company to owing £100,000’. In doing so, the tribunal referred to an earlier decision of the tribunal, *Esprit Logistics Management Limited v HMRC* [2018] UKFTT 287 (TC); however, it recognised that the facts of *Esprit* were different, in that the substance of the release of the loans in that case were the conferring of a reward on the directors.

The tribunal also referred to the Court of Appeal’s decision in *Collins v Addies (HM Inspector of Taxes)* [1992] STC 746. That case is authority for the proposition that the novation of a debt can be a release for the purposes of what is now s 415.

On the basis of these principles, the tribunal proceeded to ask itself whether there had been a release in the present case. It addressed that question by looking at all the circumstances of the case as suggested by *Esprit*. The tribunal analysed the wording of the agreement and concluded that there was a release of the full £1 million debt as set out in clause 4.1. Indeed, the agreement provided that the £100,000 repayments would amount to full and final settlement of the amounts otherwise owing to the company. As the agreement was ‘fully and effectively binding’ on the date it was entered into, the tribunal concluded that the release was effective during the 2013/14 tax year.

The Englands’ appeal was therefore dismissed.

Commentary

Students of contract law will come across a series of cases that consider to what extent debts can become validly released, given the need for ‘consideration’ to pass both ways if a contract is to be formed. However, those issues were not addressed in the present case and, I think rightly, the tribunal proceeded on the basis that the agreement in the present case would be effective in reducing the debt from £1 million to £100,000.

For the reasons that follow, however, it is somewhat unfortunate that the actual agreement was not reproduced in the decision. Instead, we have only the First-tier Tribunal’s commentary on what the key terms said. However, even on that basis, it appears that the First-tier Tribunal has possibly reached the wrong conclusion. (I fully recognise the possibility that the commentary could have misled me and that the tribunal’s conclusion is in fact consistent with the agreement’s actual terms, even if not consistent with the tribunal’s commentary.)

A lot of the tribunal’s discussion appears to focus on matters that were either not in dispute (or should not really have been relevant to the question as to when the Englands were released from the £1 million debt). In contrast, very little time was spent on the key question at the heart of this case, being whether the agreement itself amounted to a full release of the £1 million debt.

On that point, the tribunal concluded that the agreement was to be fully and effectively binding as soon as it was entered into. However, that in itself should not be surprising, as most agreements are expected to be binding immediately, even if they can be subject to future events that are not certain to occur. More importantly, it does not appear to me to be the relevant question. As the tribunal noted, the agreement would lead to the release of the £900,000 balance; however, that was conditional on certain payments being made under the instalment plan agreed.

As a result, the tribunal appears not to have asked itself the question as to when the Englands could say that they ceased to be obliged to pay the full £1 million. In my view, the agreement seems to say that there remained a risk that the Englands would have to pay the full sum until the moment that the final £77,000 instalment was paid by them (and assuming that it was paid on time). Indeed, as the Englands had argued, HMRC’s position would suggest that the Englands would have been assessed on the release of the £900,000 balance at a time when they could still have been liable to repay the same amount to the company.

What to do next

If my concerns are correct, then I would hope that the Englands would take the case to the Upper Tribunal.

Irrespective, however, of the correctness of this particular decision, the case does serve as a reminder that the wording of loan releases can impact upon the tax year in which a tax charge arises. Sometimes, this can be a mere question of cashflow. However, where marginal tax rates are different in different tax years, the timing can become even more significant. Furthermore, if the tax charge is reported in the wrong tax year, that could (depending on the circumstances) lead to penalties as well.