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Dear Ms Milner

Revenue Law Committee response to reform of close company loans to participators rules

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Revenue Law Committee.

Thank you for the opportunity to comment on the proposed changes to the loans to participators rules. Our view is that none of the proposed options should be pursued. Instead, the charge should be abolished and replaced with a similar charge levied at dividend tax rates on participators.

Fundamentally a tax system should not seek to tax the advance of a loan, since no transfer of value results from that transaction. Loan advances should only be targeted in circumstances where the loan is made in place of an alternative transaction which would be taxable, in an attempt to avoid tax. However, it must follow logically from the above that the appropriate way to tax a loan in such circumstances is to replicate the transaction which the loan replaced. This of course is the basis of the approach taken in the disguised remuneration code, for all the serious flaws in that legislation. Any other approach lacks conceptual and intellectual justification.

We would note in that context that the existing loans to participators regime (along with the disguised remuneration regime) lacks any motive defence and so has the potential to apply in cases where nothing that could be construed as avoidance is taking place. Perhaps most obvious would be the situation where a close company without distributable reserves needs to get cash to a non-employee participator. Clearly there

can be no question of an employment benefit in such a case, but equally it would not be open as a matter of law for a dividend to be paid. In that sense the existing rules are an extremely blunt instrument, although they have the virtue of increased certainty which a motive test might erode.

We would take issue with the assertion that the loans to participators rules should be seen as a measure to prevent the avoidance of employment income and national insurance charges. To our knowledge this was not, contrary to the assertions in the consultation document, their original purpose, and it should not be regarded as their purpose now. Most obviously we would point out that there is no requirement that a participator be an employee or officer of a close company in order for the rules to apply, and it is clearly wrong to seek to levy employment taxation on genuine non-employees.

The purpose of the loans to participators rules should remain solely the prevention of avoidance by disguising dividends as loans. Participators, broadly, are equity holders in companies in the economic sense. The badge applied to persons within the scope of the rules is that of equity holder, not employee. It is in our view clear that where the rules apply, the equivalent non-abusive transaction should be regarded as a dividend for tax purposes. Even where the participator is also an officer or employee, these rules by definition apply to him in his capacity as equity holder. They are nothing to do with employment tax.

In this context we would also note that the disguised remuneration rules as originally drawn would have caught loans from employers to employees and potentially taxed those loans as if they were employment income. This aspect of the rules was withdrawn following representations, including by us, that it was inappropriate. With that policy decision taken, no attempt should be made to reintroduce that policy by the back door.

We therefore disagree fundamentally with the stated primary objectives for the regime. Attacking the avoidance of employment taxation should be nothing to do with a regime targeted at abuses by equity holders in their capacities as such.

The origin of the 25% tax charge was to replicate the advance corporation tax which would have been payable by a company if it paid a dividend. At that point the charge was conceptually valid, since it operated to replicate the company's position if it had carried out the non-abusive transaction. In our view the continued existence of the loans to participators charge has been anomalous ever since advance corporation tax was abolished.

That said we understand the need to prevent the avoidance of tax on dividends by their effective replacement with loans. But our very strong view is that the anti-avoidance measures adopted to address such avoidance must do no more, or less, than replicate the position which would pertain if a dividend was paid. So, when the conditions are met, a participator should be taxed on the receipt of a loan as if it was a dividend from a UK company. No amount should be payable by the company, just as no withholding or other tax is required to be paid by a UK company paying a dividend. Similarly no UK tax charge should arise on an overseas participator receiving a loan, just as no UK tax charge would arise if such a person received a dividend.

Of the current proposals we consider that making no change is the least damaging, since this involves the lowest temporary tax charge and does not involve a permanent tax cost, albeit that it leaves a conceptually unjustifiable tax charge in place. Our view is that the correct reform of the rules would have the following characteristics:

- It should not be seen as a measure targeted at the avoidance of employment income tax charges and National Insurance. There is already a regime in place to attack such avoidance using loans in the shape of the disguised remuneration code, where a positive (and in our view correct) decision was taken to exclude loans from employer companies in a change to the original proposals. The loans to participators regime should tackle disguised dividends exclusively.

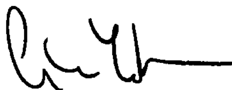
- No tax charge should arise on a close company which makes a loan to a participator.

- A participator in receipt of a loan from a close company should be taxed on that loan exactly as if he had received a dividend from that company in a given tax year if the loan is outstanding on the 5 April at the end of the relevant tax year. If the loan is repaid by that date, no charge should arise. If the loan is repaid later, the tax previously paid should be reclaimable through the relevant later year's tax return. Anti-avoidance provisions to prevent the refreshing of loans akin to those recently added to the existing regime would clearly be appropriate.

- Whilst the main charge should be unrelated to employment, it would be appropriate to clarify that if a loan is made to a participator who is also an employee and that loan is later waived by reason of the employment, then the waiver should be subject to employment taxation. Similarly, a loan to an employee participator at a sub-market rate of interest would be capable of attracting employment taxation on the benefit represented by the reduced interest rate.

A regime with these characteristics would form a coherent part of the UK tax regime. The existing regime, along with all the proposed possible changes to it, lacks that coherence. Its purpose (of preventing avoidance by disguising dividends as loans) has evidently become muddled, and the rates of tax it imposes are consequently entirely arbitrary. It has no place in our tax system.

Yours faithfully,



Simon Yates
Co-Chair
The City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

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