Writing Off Directors' Loans: Taxing Times!

Director's loan accounts (DLAs) are a common feature in the financial statements of family and owner-managed companies particularly. HM Revenue and Customs (HMRC) are keen to ensure that DLAs are treated correctly for tax and National Insurance contributions (NICs) purposes, and regard DLAs as a 'risk' in terms of potential errors.

Such is HMRC's concern that they have published a 'Directors Loan Account Toolkit' (tinyurl.com/HM-RC-DLA-Toolkit), which provides guidance on risk areas where errors often occur. One such risk area is the release or writing-off of a DLA.

Loan releases

A 'close' (i.e. broadly a closely-controlled) company is charged tax (at 32.5%) in certain circumstances where the company makes a loan to a 'participator' (e.g. shareholder), commonly in respect of the overdrawn loan account of a director shareholder (CTA 2010, s 455). Where this tax charge arises, relief is generally available to the extent that the loan is subsequently repaid, released or written off.

However, where the loan is released or written off, income tax is charged on the shareholder at the same rates as dividend income. The dividend higher rate (i.e. 38.1% for 2018/19) compares favourably to the highest rate of income tax on a salary or bonus (i.e. 45%). Tax planning arrangements in respect of DLAs have been popular over the years. However, HMRC has often challenged them.

How are they taxed?

For example, in Esprit Logistics Management Ltd and Ors v Revenue and Customs [2018] UKFTT 287 (TC), the appellants (in four separate appeals) were involved in similar directors' loan waiver schemes. Under the arrangements, a board minute explained the company's wish to release sums owing by the director by way of a bonus for the director's services to the company, and a deed was executed setting out the sums released. The company did not pay employment income tax on the released amounts, and deducted the sums released from company profits. HMRC challenged the schemes. Income tax determinations were made, and corporation tax closure notices were issued by HMRC for the tax years 2006/07 to 2009/10. The appellants appealed.

The appellants argued that the amounts released were taxable income of the directors at dividend tax rates (under ITTOIA 2005, s 415). HMRC contended that the amounts were taxable as employment income (under ITEPA 2003, Pt 2), on the basis that the waivers of the loans were, in reality, reward for the directors' services. On the issue whether ITTOIA 2005, s 415 applied, the First-tier Tribunal noted that the documentation reflected that the company wanted to award the directors sums, so they could pay off their loans, but instead of handing over the money only for it to be handed back to make the repayment, the company reduced the directors' indebtedness. The tribunal concluded on the facts that the transaction between the company and the director amounted to a repayment of the relevant

loan, and that the appellant companies did not 'release' the loans for the purposes of the ITTOIA 2005, s 415 charge.

Other tax implications

The tribunal in Esprit Logistics Ltd did not decide a further tax issue, namely whether the loans to the directors were 'loan relationships' and whether the release of the loans was deductible for corporation tax purposes under those rules. However, it should be noted that the loans in that case were made before a change in law (from 24 March 2010), which denies a loan relationship deduction where a loan to a close company shareholder is released or written off (CTA 2009, s 321A).

If a loan is 'repaid' instead of released by being written off in lieu of remuneration, the company may be entitled to a tax deduction as employment income. However, the 'flip-side' is that PAYE and National Insurance contributions (NICs) will apply to the relevant amount. Unfortunately, the decision in Esprit Logistics Ltd was made in principle, and no decision was made by the tribunal on whether any PAYE obligation arose as earnings. However, the company paid NICs on the amounts written off.

HMRC's view is that if the shareholder is also an employee, an amount released or written off will attract Class 1 NICs if it is remuneration or profit derived from an employment (SSCBA 1992, s 3(1); see HMRC's Company Taxation manual at CTM61660). HMRC cites Stewart Fraser Ltd v RCC [2011] UKFTT 46 (TC) as authority, although that case does not create a binding precedent and was decided on its particular facts.

Practical Tip :

For shareholders who are also employees, the write-off of a loan falls to be treated as earnings for income tax purposes (ITEPA 2003, s 188). However, where loans to participators of close companies are released and tax is chargeable under CTA 2010, s 415, that tax treatment takes precedence over the employment income charge. A double tax charge is therefore prevented (ITEPA 2003, s 189).

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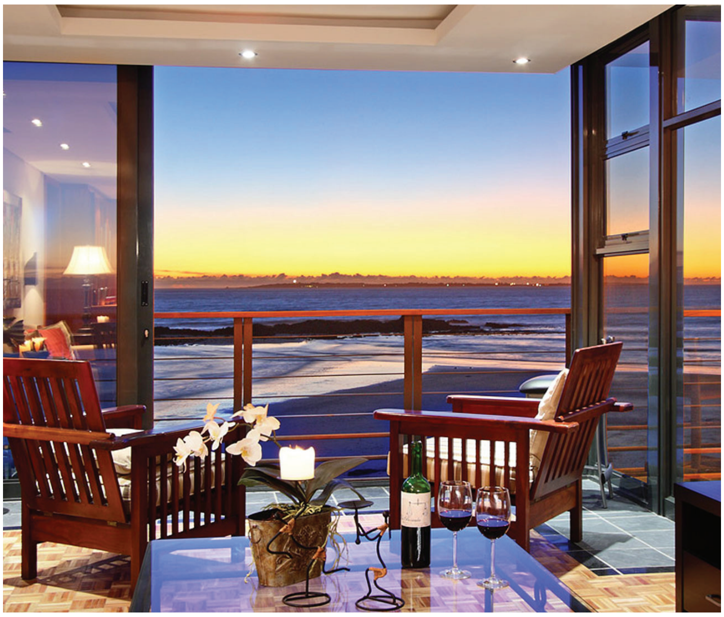


IHT and Holiday Lettings: A (Rare!) Business Property Relief Success

Inheritance tax (IHT) relief at the rate of 100% is an attractive proposition. Business property relief (BPR) is available to business owners if certain conditions are satisfied. BPR at the 100% rate applies to 'relevant business property' including a business or interest in the business (in certain other cases, BPR is available at 50% instead).

Unfortunately, not every business potentially attracts BPR. There is an exclusion from BPR (subject to certain limited exceptions) if the business consists wholly or mainly of (among other things) 'making or holding investments' (IHTA 1984, s 105(3)).

Perhaps unsurprisingly, the absence of a statutory definition of 'holding investments' has caused disputes between taxpayers and HM Revenue and Customs (HMRC), resulting in a number of court and tribunal cases.

Holiday accommodation

The availability of BPR in respect of holiday accommodation businesses has been one such area of dispute. HMRC sometimes contend that there is no 'business' at all. Even if the taxpayer jumps this hurdle, HMRC will often resist BPR claims on the basis that the activities fall within the above exception for investment businesses.

HMRC considers that furnished holiday lettings will generally not qualify for BPR (see HMRC's Inheritance Tax manual at IHTM25278). BPR claims have been unsuccessful in several cases, most notably Lockyer and Robertson (Personal representatives of Pawson) v Revenue and Customs [2013] UKUT 050, and also in Green v Revenue and Customs [2015] UKFTT 334 (TC) and Executors of the Estate of Marjorie Ross (Deceased) v Revenue and Customs [2017] UKFTT 507 (TC).

However, an appeal against HMRC's rejection of a BPR claim in respect of a furnished holiday lettings business was successful more recently, in The Personal Representatives of Grace Joyce Graham (Deceased) v Revenue and Customs [2018] UKFTT 0306 (TC) ('Graham').

'Exceptional' services

In Graham, an individual (GJG) ran a business involving the provision of accommodation in four self-contained, furnished, self-catering flats or cottages, which were part of an enlarged old farmhouse (C) in the Isles of Scilly.

The guest facilities included a games room with a snooker table, table tennis, board games and videos, a sauna, laundry room and a barbecue area. There was also a heated swimming pool. Covered areas housed a golf buggy and bicycles, which were available to guests for payment. Inside the house was a separate guest lounge with a collection of books and an open fire (in season). A range of services was provided to guests. For example, on arrival at C guests were offered refreshments; they were helped to their accommodation and given a 'welcome pack' which included a 'what's on' guide to the week. At the start of each visit each flat was supplied with flowers, home-made marmalade, sometimes wine (or occasionally champagne), home-made bread, milk, tea, coffee, sugar, toilet rolls, soaps and shampoos, washing-up liquid and lavatory bleach. The cottages were occupied by guests between about April and October. Running the business required in total about 200 hours work per week by GJG's daughter with assistance from GJG and others.

GJG died in November 2012. On submitting an IHT account for her estate, GJG's personal representatives claimed BPR on her interest in C. However, HMRC rejected the BPR claim, on the basis that the business was mainly one of holding an investment (within IHTA 1984, s 105(3)). The personal representatives' appeal was allowed. The First-tier Tribunal concluded that C was an 'exceptional case' which just fell on the 'non-mainly-investment' side of the line. An 'intelligent businessman' would regard it more like a family run hotel than a second home let out in the holidays.

Compare and contrast?

It might be thought that comparing and contrasting holiday accommodation in a particular case with (say) a small hotel would be instructive. For example, in Graham the tribunal noted that:

- Certain services and activities were found both in a normal small hotel or guesthouse and at C (e.g. a room for the guests' sole occupation, towels and linen, cleaning, tourist information, tea coffee and milk, a reception and a communal sitting room).
- Some provisions and activities were found at C but not generally at smaller hotels (e.g. swimming pool, sauna, bikes to hire, games, a large ornate garden, marmalade and other provisions, and the welcome given to guests).
- Other services and activities would normally be provided at a hotel or guesthouse but were not provided at C (i.e. meals, a bar (in larger hotels), the daily making of beds and cleaning/tidying, and room service in larger hotels).

However, noting these differences and similarities did not help the tribunal to reach a clear conclusion.

Practical Tip :

HMRC's guidance in IHTM25278 acknowledges: 'There may however be cases where the level of additional services provided is so high that the activity can be considered as non-investment.' Each case should therefore be considered based on its own facts.

HMRC Enquiries: How To Keep Private Records Private!

Any taxpayer who submits a tax return can be selected for an HM Revenue and Customs (HMRC) enquiry at random. Those taxpayers unfortunate enough to be selected may find HMRC's tax return enquiries rather obtrusive.

For example, HMRC sometimes request a taxpayer's private records. A controversial topic in enquiries is whether HMRC is entitled to access those records. Self-employed taxpayers (or those with rental property businesses) are particularly at risk of being asked by HMRC to provide copies of private bank and credit card statements, especially if those accounts have been used for both business and private purposes.

Is HMRC entitled to see a self-employed taxpayer's private records, and if so, to what extent?

It's the law

HMRC has extensive information and inspection powers. The taxpayer has a general right of appeal against HMRC's information notices, such as if the information requested is not considered to be 'reasonably required' (see below). However, there is no right of appeal if the information or document forms part of the taxpayer's statutory records.

Information or a document forms part of the taxpayer's 'statutory records' broadly if the tax legislation requires the taxpayer to keep it (FA 2008, Sch 36, para 62). For example, in the case of a self-employed taxpayer, the records to be kept and preserved include the following (TMA 1970, s 12B(3)):

- records of all receipts and expenditure 'and the matters in respect of which the receipts and expenditure take place'; and
- records of all sales and purchases of goods (in the course of a trade involving dealing in goods).

It is important that business transactions are not made through private accounts. For example, in Beckwith v Revenue and Customs [2012] UKFTT 181 (TC), over 90 business transactions went through the taxpayer's personal account during the tax year under enquiry. The personal account was therefore held to be a 'business record' and formed part of the taxpayer's statutory records. Accordingly, the taxpayer had no right of appeal against HMRC's information notice to the extent that it asked for his personal bank statements.

Let's be reasonable

Even if private records do not form part of the taxpayer's statutory records, there is still a requirement to provide information or produce a document that is 'reasonably required' to check the taxpayer's tax position.

Whether private records are 'reasonably required' has caused many disagreements between taxpayers and HMRC. Keeping business and private transactions entirely separate should help to avoid such disagreements arising.

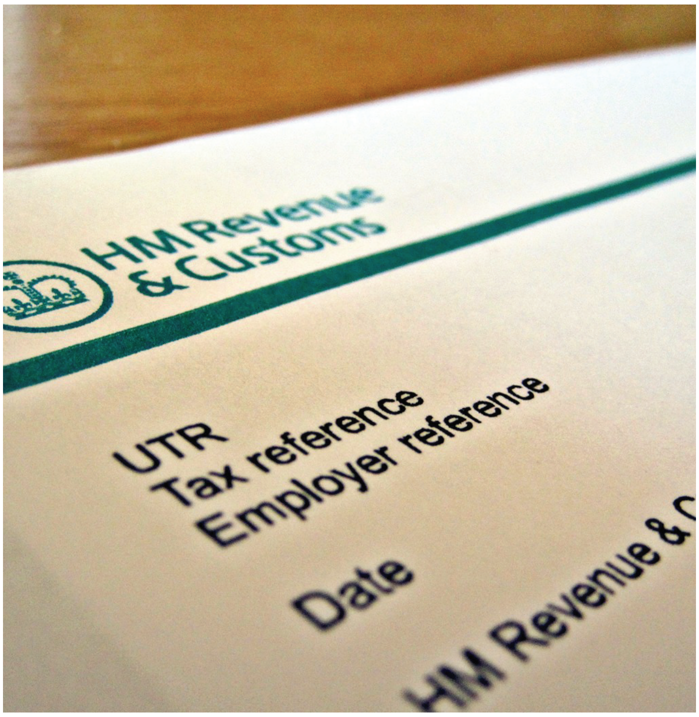
Don't get 'personal'

Even if information or documentation would otherwise be reasonably required, there are certain restrictions on what HMRC can require or inspect. These include 'personal records' (as defined in the Police and Criminal Evidence Act 1984, s 12), which broadly means records concerning an individual's physical, mental, spiritual or personal welfare. The scope of 'personal records' is therefore relatively narrow.

For example, HMRC guidance (in its Compliance Handbook manual at CH22180) points out that some medical professionals keep mixed medical and fee records in respect of patients. Where personal records contain mixed information, HMRC can require the medical professional to provide information which does not relate to any individual's welfare, by omitting the information that makes the document 'personal records' (FA 2008, Sch 36, para 19(3)).

In *Smith v Revenue & Customs* [2015] UKFTT 200 (TC), the taxpayer received rental income from various properties, but unfortunately did not operate separate business and private bank and credit card accounts. The First-tier Tribunal (FTT) held that HMRC's information notice should be varied, such that the appellant was required to provide the bank and credit card statements but omitting any personal information.

It would therefore seem (albeit that FTT decisions do not create legally binding precedents) that HMRC can request private bank and credit card statements used for mixed (personal and business) purposes, with the omission of only a limited amount of personal information, if the statements are considered to be reasonably required.



The 'private side'

In the context of an HMRC enquiry involving a taxpayer's business accounts, if HMRC establishes that the business records contain inaccuracies, this is often used as justification to extend the scope of the enquiry into the 'private side'. HMRC adds (at EM3560): 'No full private side examination can be undertaken without access to private bank account statements.' However, the guidance adds: 'You should not routinely call for them in the opening letter of an enquiry. Exceptional circumstances might be a voluntary disclosure of undisclosed business receipts into a private account.'

Even if business transactions have been fully recorded and private accounts have not been used, HMRC sometimes ask to see private account statements if drawings from the business have been lodged in them. However, it should be noted that drawings do not form part of the accounts required for self-assessment purposes.

Practical Tip:

The message for taxpayers is clear: avoid using private accounts for business transactions.

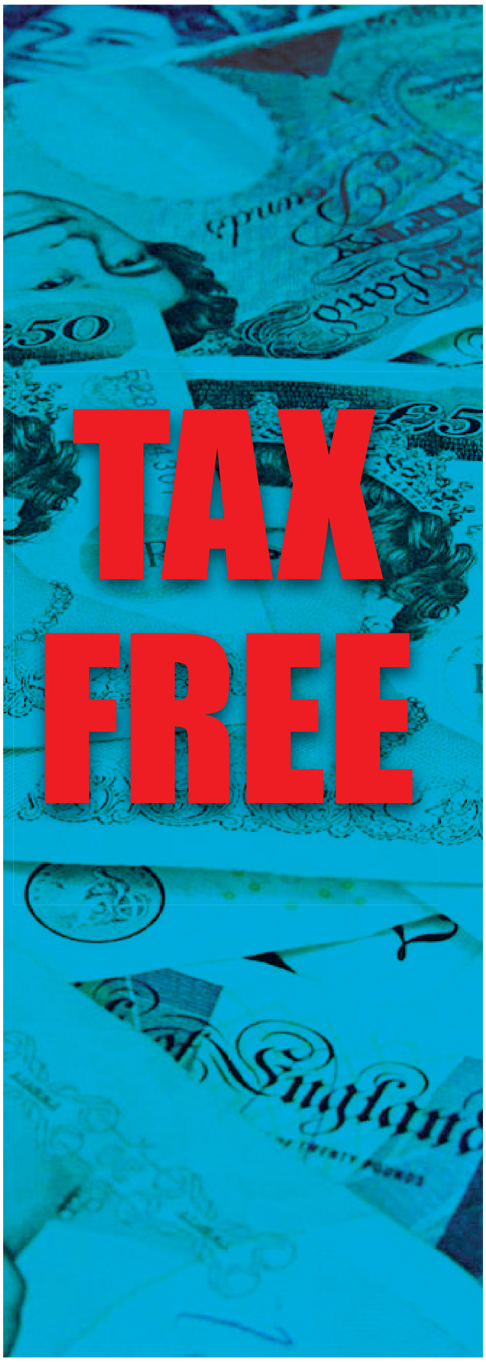
Personal Tax

Income Tax Position

If your total income is below the personal allowance, currently £11,850, then you don't have any income tax to pay.

Case Study:

Lucy receive £5,000 pension and £5,000 rental income from her rental property. As her total income of £10,000 is below the tax-free allowance there is no income tax to pay.



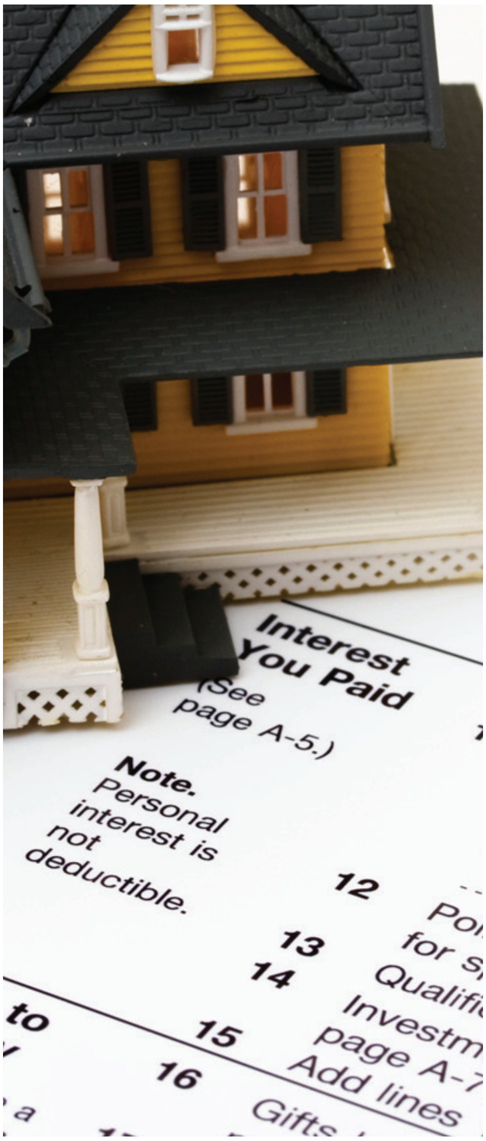
Property Tax

Joint Property And Form 17: Practical Points

It is relatively common for an asset (e.g. an investment property) to be jointly held in the names of a married couple (or civil partners). The general rule is that those individuals are treated for income tax purposes as beneficially entitled to the property income in equal shares. This is sometimes referred to as the '50:50 rule'.

Case Study:

Adam and Brenda are married and living together. Adam is a basic rate taxpayer; Brenda pays tax at the higher rate. They jointly own an investment property (i.e. Adam 75%; Brenda 25%). The property rental income is £10,000. Adam and Brenda each pay tax on income of £5,000.



Business Tax

Apportionment of Mixed Use Expenditure

Sometimes expenses will be incurred for both business and private purposes. The legislation provides that: 'If an expenses is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part, or identifiable portion of the expense which is incurred wholly and exclusively for the purposes of the trade'. They key to whether any deduction can be claimed where an expense is incurred for both private and business purposes is whether it is possible to identify the trade portion.

Sometimes expenses will be incurred for both business and private purposes. A common example of this may arise would be a mobile telephone used for both business and personal calls. From the bill it will be possible to identify the private calls and the business calls, and the cost of each

Case Study:

John has a mobile phone that he uses for home and work. He works out that 65% of his calls are business calls. In a year, his bills total £750. He can claim a deduction for £468 (65% of £750).