ENSORS

Business Borrowing – Tax Efficiently

We live in an age of economic uncertainty and many businesses are hampered by short-term cash flow issues. This is despite projections showing that the medium to long term future looks assured.

One of the key catalysts to the economic downturn stemmed from the banking sector, and the level of 'toxic' debt taken on by banks. Bad or doubtful debts are becoming an increasing problem for banks, who are increasingly anxious about the ability of borrowers to repay what they have borrowed.

All of this means that new funding is in short supply and more expensive. It therefore becomes more important than ever to review borrowing to minimise the cost. This means not only aiming to pay the lowest rate of interest but also ensuring that any financing is structured tax efficiently.

The borrowing may be necessary to grow the business, or simply to stay afloat; and businesses will always look first to the commercial considerations, such as overall debt levels and cash flows. The tax implications are thus often overlooked but these can be equally as important - both in terms of how the funds should be borrowed and by whom. Having borrowings in the right place at the right time can significantly improve tax efficiency, and therefore cost effectiveness.

There have been a number of recent tax changes that affect borrowing. While this Briefing focuses on these changes, and principally how they affect borrowing for business purposes, comment is also made on the tax planning opportunities that have survived the changes.

It is not only businesses and their owners that are affected. This Briefing also considers some of the changes affecting private individuals, particularly with regard to Inheritance Tax.

Business Borrowing: Overview of Tax Implications

The underlying principle is that a business *(including a rental business)* will get relief for interest paid *(against profits for Income Tax or Corporation Tax purposes)* if it is incurred wholly and exclusively for the purposes of the business.

Where a business borrows directly from a third party lender to the business, relief should be relatively straightforward. This is only part of the story, however, as often the principal source for the borrowing lies outside of the business or the loan is itself sourced from another family business. This may be for a number of reasons, usually commercially driven, such as using *personal* assets as security to secure a lower rate or where another business has surplus funds.

The tax legislation includes a number of provisions that apply where borrowing is not directly from a third party lender to the business. These relate to, inter alia, relief for the interest paid on a qualifying loan and tax charges that may apply to borrowing from or lending to a family company. These provisions need to be considered carefully to ensure that borrowing is structured tax efficiently.

Finally, the extent to which a loan can be deductible for Inheritance Tax purposes is of paramount importance and recent legislative changes in this area have complicated things considerably.

Each of these provisions is considered in more detail below.

Qualifying loans to individuals

As mentioned above, the interest on a loan incurred for the purpose of a business is generally deductible when calculating the profits of that business. Where an *individual* borrows to invest in his or her business, the position is not so straightforward as only certain loans qualify for relief and, in addition, there are limits on the amount of relief available.

Outline of interest relief

Income Tax relief, in the form of a deduction from the individual's income, is available for interest paid on certain qualifying loans *(including replacement loans but not overdrafts)* taken to invest in his or her business. Loans for the following purposes qualify:

1. To invest in a 'close' (see below) trading company (e.g. subscribing for shares or lending funds).

2. To, or as a contribution to, a trading partnership.

3. To acquire a share in a partnership (trading or non-trading).

Relief is given if certain conditions are met when the interest is paid. There are separate conditions for the different types of loan but, broadly, relief is given if the funds are *used* for the purpose of the business *(except in the case of acquiring a partnership share) and* the individual has a requisite interest in the business.

So far so good! However, Finance Act 2013 introduced a cap on the Income Tax relief for the interest paid on such loans.

Cap on interest relief

From 6 April 2013 Income Tax relief for interest paid on qualifying loans has been subject to a cap. That cap is the higher of £50,000 or 25% of an individual's income *(net of pension contributions but gross of charitable donations)*. Any unrelieved interest cannot be carried forward or back and it does not matter when the loan was taken out.

However, it is not only interest on qualifying loans that the cap applies to; it also applies to the total of all relevant reliefs claimed by the individual (i.e. rather than each relief having its own cap) and other reliefs include, inter alia, trading losses set against other income and relief for losses on shares in unquoted trading companies.

This new restriction can therefore significantly affect the tax efficiency of business borrowing outside of the business, particularly where other reliefs are being claimed.

Practical considerations

The capping of reliefs may mean that direct borrowing by the business *(possibly with a personal guarantee to achieve a lower interest rate)* is favoured where personal borrowing exceeds a certain level. Capping does not apply to borrowing within the business, so even where a business loan is attainable only at a higher rate of interest, additional tax relief may mean that there is a lower overall cost. This is, of course, subject to the over-riding requirement that the business has profits against which to set interest.

In the case of a close company loan the only real downside to an external loan is that the loan is outside *the protection of the company's limited liability and so would remain payable even if* the company went out of business. This particular point is becoming less relevant, though, as lenders are increasingly seeking guarantees from directors when lending to close companies.

Profit extraction

Where it is still most appropriate to borrow outside of a close company and these funds are lent to the company it is generally tax efficient to charge interest as profit extracted in this way does not attract national insurance contributions. Furthermore, interest paid by the company at a commercial rate *(e.g. the rate paid by the individual)* will be tax deductible. So if the company pays the individual the same rate as he pays it will be tax neutral for the individual and effectively the tax relief for the interest sits in the company.

Trustees

It may be that it is cost-effective to source borrowed funds from a family trust. One important point to note is that income tax relief is only available to *individuals*. Therefore relief would not be available to the trustees of the family trust.

Qualifying loans: capital gains relief

As a final point, it is worth noting that loans to a trading company that become irrecoverable qualify for capital gains relief to the extent of the amount irrecoverable. Relief is also available on payments under personal guarantees given for borrowing by the company.

Inheritance Tax deduction for loans

Inheritance Tax is calculated by reference to a person's 'net estate' (i.e. assets less liabilities). Generally, liabilities are deducted only to extent that they are incurred 'for consideration' – which is to say that simply handing an IOU to someone who has *not* lent anything to you does not create a deductible liability.

There are likewise anti-avoidance rules which prevent an individual giving something away and then receiving it back as a gift; however, prior to Finance Act 2013, all other loans were generally deductible for Inheritance Tax purposes.

Further, the general (and, before Finance Act 2013, only) rule is that where a liability is an 'incumberance' on a property it is deductible against the value of that property. Therefore, historically, it has been possible to reduce a person's estate by borrowing against a property which is subject to Inheritance Tax and use the funds to acquire property qualifying for relief e.g. property qualifying for Business Property Relief or property that is Excluded Property. The liability would then reduce the value of the estate while the asset acquired would not increase it.

Three new rules have been added to these general rules, and apply to both individuals and trusts for events occurring on or after 17 July 2013.

Liabilities not discharged on death

The first, and most general, new rule is that a deduction will be available only to the extent that the liability is actually repaid. This applies to all loans regardless of when they were incurred.

There is, however, an exception to this rule - there is no restriction where there is a commercial reason why the loan is not repaid and which does not form part of tax avoidance arrangements. Further, there is a general assumption that there would be a commercial reason for non-payment in the case of a loan due to a third party on commercial terms.

In other cases, however, a loan will need to be repaid post-death in order to claim a deduction - an example might be where a loan is due to a family member or family trust. Interestingly, HMRC have confirmed that it is in order for personal representatives take a new loan to discharge one outstanding at the date of death.

Tension with Stamp Duty Land Tax

However, the personal representatives taking out a new loan creates tension with Stamp Duty Land Tax. Where the recipient of a gift takes over responsibility for a loan on the property, the loan taken on is treated as chargeable consideration for Stamp Duty Land Tax purposes. This rule is waived for loans taken on by a beneficiary of an estate but not where the personal representatives have taken a replacement loan which is subsequently transferred to the beneficiary. HMRC have confirmed that they are aware of this tension but have indicated that they do not intend to amend the Stamp Duty Land Tax provisions.

Liabilities and relievable property

The other two rules concern liabilities taken out to 'acquire' (or 'maintain' or 'enhance') certain property which is outside the scope of Inheritance Tax.

One rule provides that a liability incurred to acquire business property, agricultural property or woodlands will reduce the value of those assets first. Thus, using the example above, even if the liability is secured on property which is subject to Inheritance Tax, it will not reduce the value of the net estate.

A similar rule applies where 'excluded property' is purchased – for example, non-UK property held by a person not domiciled in the UK.

Both rules include wide anti-avoidance provisions so that the rules cannot be side-stepped by 'indirect' investment in these relievable assets.

A deduction is available though for loans exceeding the value of the relevant property but only to the extent of the excess *(and subject to the over- riding rule above on liabilities not discharged on death)*.

These restrictions for liabilities used to acquire excluded property apply regardless of when they were incurred; however, the first restriction – in relation to business property, agricultural property or woodlands - applies only to liabilities incurred on or after 6 April 2013. For these purposes a liability is incurred when the agreement is made or, where there is no agreement, when the cash is transferred.

Where an existing loan is varied, the *date of the variation* is the relevant date and great care is therefore required where loans are being re-financed because in some circumstances, the ability to deduct a pre-6 April 2013 loan can be lost.

Finance Act 2014 will extend the restrictions to UK based foreign currency bank accounts held by individuals who are both non-UK resident and non-UK domiciled. Such accounts are not taken into account for Inheritance Tax on death but are not excluded property so currently loans to fund them do not fall within the above restrictions. The extension to include such loans will apply from the date Finance Act 2014 is given Royal Assent, regardless of when the loan was taken out.

Borrowing from another family company

Where an individual borrows from his or her family company, different rules apply.

Family companies are usually close companies *(broadly, owned by five or fewer shareholders)*. Such companies are liable to a tax charge (under s455 Corporation Tax Act 2010 - *a "s455 charge"*) when a loan is made to a participator (*a shareholder)* or an 'associate' of a participator, and the loan remains outstanding nine months and one day after the end of the company's accounting period. The charge is 25% of the loan which is refunded following the loan being repaid or written off.

Prior to FA 2013 it was possible to avoid the charge if such a loan was temporarily repaid (*before the 9 month deadline and known as 'bed and breakfasting'*) or by making the loan to an intermediary such as a partnership or trust. Finance Act 2103 tightened up the rules from 20 March 2013, as follows:

Temporary loan repayments

A restriction has been introduced for the 'bed and breakfasting' of loans. This applies where a loan is repaid before the s455 charge becomes payable and a new loan is taken out within 30 days or, where the loan is for £15,000 or more and there are arrangements in place at the time of repayment for a new loan to be made <u>at any time</u>.

Where these rules apply, the repayment is ignored for the purposes of determining the amount of loan subject to the s455 charge. The amount ignored is the lower of the amount repaid and new loan taken out. For example suppose there is a loan of £750,000 which is repaid a week before the s455 tax becomes due but within 30 days a new loan of £500,000 is taken out. The amount of the repayment that is ignored is £500,000 and this will be subject to the s455 charge. Prior to the new rules there would have been no s455 charge.

Loans to intermediaries

The rules were also changed to end any doubt that a s455 charge arises on a loan to an intermediary. This affects new loans made on or after 20 March 2013 to:

1. Any partnership where an individual is both a shareholder in the company and a partner in the partnership; or

2. A trust in which at least one trustee or beneficiary (or potential beneficiary) is a shareholder in the company.

A typical example of a partnership scenario this new rule will catch is a 'mixed partnership'. This is one where one of the partners is a company and the other partners are shareholders in that company.

The new rules will also catch situations where the company does not draw its share of partnership profit but an individual partner draws more than theirs. The overdrawn amount will be treated as a loan on which a s455 charge can arise.

Practical considerations

Using loans which rely on temporary repayments to avoid a s455 charge are no longer likely to be tax efficient. Such arrangements should therefore be reviewed for alternatives.

Similarly, arrangements involving loans to intermediaries should also be considered carefully as new loans are much less likely to be tax efficient. Existing loans should be isolated and new loans issued on different terms and placed in a different account.

Conclusion

The various changes affecting the tax treatment of borrowing will mean it is more important than ever to consider financing carefully. Both the commercial attractiveness and the tax treatment will need to be considered together to determine the overall cost-effectiveness.

Unfortunately, the new rules on loans to intermediaries in particular may make some commercial arrangements very tax inefficient indeed. For example, where a family company has spare funds it may make commercial sense to lend to a family partnership which is in need of finance. This could be because the partnership either cannot get the finance it requires or it is simply more cost-effective to structure the finance in this way. The new rules on loans to intermediaries will have a significant impact on such arrangements even though they are for commercial reasons.

It will not only be new financing that needs to be considered. Existing arrangements using any of the methods highlighted above will also need to be considered and there can be no substitute for detailed professional analysis and advice.

While such analysis will inevitably focus on the changes, a holistic approach will be needed to consider not only the changes but other tax provisions on borrowing. For example, it is still possible to carry out a loan restructuring exercise to make more tax efficient use of the capital within a business (*particularly property rental businesses*). Funds can be borrowed by the business, with tax relief for the interest, and these funds are then drawn out as a capital distribution to use for other purposes e.g. repaying the mortgage on a main residence.

Failure to take appropriate advice can prove very expensive in tax terms and we would be happy to advise you or a member of your family if you are considering taking out significant finance or would just like to see if your existing loans can be structured more tax efficiently.

For further information on any of the issues discussed please contact Robert Leggett on 01473 220022 or email robert.leggett@ensors.co.uk.