LOANS TO PARTICIPATORS: A PRACTICAL POINT

by Laurent Sykes

Issues under the "loans to participators" rules (formerly contained in s.419 ICTA 1988 and now in s.455 CTA 2010) can easily arise unexpectedly, for instance where a close company is treated as making a loan to a participator because the participator incurs a debt to the close company (even where the due date of payment does not arise until a later date). Similarly a loan by a close company to a partnership of which a participator is a partner (or a debt incurred by such a partnership to the close company) can also give rise to a charge even though the loan is to the partnership, and not to the participator.

It may be that there are amounts due from the close company to the participators. It is not axiomatic that they will be taken into account in reducing the debt owed to the close company for the purposes of s.455 and in calculating the net amount outstanding nine months after the end of the accounting period. HMRC sometimes cite an unreported Special Commissioners' decision summarised in "Taxation" on 26 August 1988 in which the Special Commissioners refused to set undrawn remuneration owed by a close company to its director against amounts owed by the director to the close company for the purposes of working out the unpaid loan or advance. The aim of this article is to explore this a bit further.

In a case where there are amounts owed in both directions there are generally two possible bases for treating the "debt" owed to the close company by the participators as reduced by amounts going the other way, namely where -

(a) each amount initially represents a separate debt but there is a periodic setting off of one debt against the other;

(b) the agreement between the parties is that those different amounts should be combined for the purposes of determining the debt due as between the parties at any point in time, and therefore there is only ever a single debt – which is referred to here as an agreement to "combine" accounts.

Periodic set-off

There may be an agreement to set off separate debts which co-exist up until that point (or alternatively the right to do can arise as a matter of a law). It will be important to show that such a setting off has in fact been effected. Until it has been, separate debts continue to exist.

Combination

However an agreement to set off may not be needed because it is always the intention that there is only one debt of the balance. An example of the type of "open account" involved is described in *Ramsden v CIR* 37 TC 619, where expenses incurred by the taxpayer on behalf of a company reduced the balance due from the company to the taxpayer in respect of the purchase price of shares from the taxpayer.

Halsbury's Laws (formerly 3rd Edn, vol 34, p396, para 673[1]) describes the right of set-off as "the right to plead a debt due from the plaintiff, arising from a separate transaction, in reduction or extinction of the plaintiff's claim". The editors go on to note that, in contrast to set-off, "where opposing demands are connected by originating in the same transaction, the balance has always been regarded by the common law as the debt, so that no question of set off arises". These statements in Halsbury's were approved by the Court of Appeal in *Henriksens Rederi A/S v P H Z Rolimpex* [1973] 3 All ER 589 (at 593) on the basis of the decision in *Green v Farmer* (1768) 4 Burr 2214. Here Lord Mansfield said (at 2221) that "[W]here the nature of the employment, transaction or dealings, necessarily constitutes an account consisting of receipts and payments, debits and credits, it is certain that only the balance can be the debt…".

Winn LJ in *Rolls Razor Ltd v Cox* [1967] QBD 552 (at 574), in the context of the Insolvency Act definition of "mutual dealings", gave a further example of an open account (or alternatively an example of a course of dealing in which it is implicit that set-off will happen periodically):

> "...Similarly, producers of such commodities as fruit and vegetables, who market them through selling agents in, for example, Covent Garden, normally, if not necessarily, deal with those selling agents upon a running account in which credits in their favour will arise in respect of proceeds of sales received by the agents, with related debits for commissions and sale expenses incurred by the agents in disposing of the goods or making allowances for quality deficiencies. These are only examples which could be almost indefinitely multiplied by taking into consideration such other relationships as those of a landlord and his rent collectors, or transactions of collection of outstanding debts. The common and essential characteristic of all such dealings, which I regard as the type of mutual dealings contemplated by the section, although many others less comprehensive and of shorter continuity would also be included, is that by the intention of the parties expressed or implied, they each extend to the other credit in respect of individual sums of money until such time as such sums are brought into account and in the account set off against other sums, in totality, in respect of which the other party has given credit...."

The evidence

The question of whether accounts should be combined in ascertaining the debt owed to or by the company is, as noted, a matter of determining the agreement between the parties. As Roskill J put it, in the first instance decision of *Halesowen Presswork v Westminster Bank* [1970] 2 WLR 754 (at 771) which concerned a number of bank accounts: "The question to be asked in every case is: 'what was the agreement'?". If there is no written agreement between the company and the participator, the terms of the agreement in any particular case must be derived from the course of dealing between the parties. Regard must be had to previous dealings, general usage or other relevant facts and circumstances (see *Dodd v Wigley* (1849) 7 CB 105 and the Australian case of *Pioneer Concrete Pty Ltd v L Grollo & Co Pty Ltd* [1973] V.R. 473).

Importantly, the fact that different accounts have been used for internal book-keeping purposes is not determinative of the question of whether each account represents an individual debt. Nor is there a basis in law for the proposition that the use of multiple accounts for internal record-keeping requirements necessarily gives rise to multiple debts – indeed the presumption in the banking context is the very opposite. There is no "short-cut" to ascertaining the agreement between the parties. The first instance decision in *Halesowen Presswork v Westminster Bank* provides clear support for this. The case concerned the question of whether a bank account in debit and a bank account in credit were to be combined or consolidated. Roskill J said (at 770):

> "…the existence or absence of the right cannot, in a case such as the present, in my judgment turn upon the actual form in which the book entries in the bank's books were made or upon the absence from those books of any physical consolidation or combination."

It may simply be for convenience that different accounts are used to record aspects of a single debt. Convenience was cited as a ground for the use of different accounts in the case of *In re European Bank* (1872) LR 8 Ch App 41 at paragraph 20 (which concerned a number of bank accounts kept as between bank and customer). Nevertheless, the treatment in the accounts, particularly the statutory accounts, is clearly a relevant factor to be taken into account. The fact that the amounts have not been brought together in a single t-account but are recorded separately is however by no means determinative.

The absence of payment by either party, despite a course of dealing over a prolonged period, raises a "strong presumptive argument of an agreement" to combine or set off amounts - see *Downam v Matthews* (1721) Blackst. Rep. 653. *Downam v Matthews* concerned a course of dealing between a cloth merchant and a cloth dyer (the plaintiffs sold cloths to the defendant and owed money to the defendant in respect of the dying of other cloths) over a course of several years without payment of money on either side. The reported case contains the following:

> "But Lord Chancellor said, that though generally stoppage was no payment, and that there were some cases where this could not be done, as a man could not stop his rent for money owing to him, or a bond toward satisfaction of a simple contract debt; yet in cases of this nature, where it appeared that the mutual dealing between the intestate and the plaintiffs were carried on for several years in this manner, without payment of money on either side, it was a strong presumptive argument of an agreement to this purpose, and that without such liberty of retaining against each other they would not have continued on their dealings; but if it had been insisted upon by either party, that the other should not be allowed to off his debt out of what was owing by him to the other, as they could, that this would have soon broke of all dealings between them."

That inference might also be said to be present if any payment which *is* made is made by reference to the aggregate balance.

So it will be worth investigating the facts fully before accepting an argument that a s.455 charge arises by reference to the liabilities incurred by the participator to the company without taking into account the amounts owed by the close company to the participator.

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[1] The current edition, vol 42, para 421, footnote 3 states "Where there was a running account of connected transactions, the common law regarded the balance as the debt so no question of set-off arose: *Green v Farmer*…"