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PRACTICE NOTE

PN 106/04

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LOANS TO PARTICIPATORS

Differential Tax Rates: Anti Avoidance

INTRODUCTION

These provisions have been introduced to prevent the avoidance of a liability to Manx income tax through the exploitation of loans to participators.

They are intended to apply only to loans made to individuals resident in the Isle of Man and will not apply to any loan made to a non resident. Where necessary, the Division will require to be satisfied that any loans to non resident persons are not being made through a structure for the benefit of persons resident in the Isle of Man.

Equally, they only apply in respect of a company the whole or part of the profits of which are chargeable to income tax at a rate less than the higher rate applicable to individuals. They will not apply to any company from which a resident interest is excluded, for example International Companies.

The measures are introduced by Part 4 and Schedule 3 of the Income Tax (Amendment) Act 2004, which inserts subsection (10) after subsection (9) of section 2H and new sections A108 to J108 before section 108 of the Income Tax Act 1970. The relevant sections of the legislation are attached for ease of reference.

EFFECTIVE DATE

Loans made on or before 1st October 2004, or any parts thereof that are repaid or written off/released from debt after 30th September 2004, do not fall under these provisions (but may give rise to a charge under section 2G).

STATUTORY REFERENCES

All references are to sections of the Income Tax Act 1970 as amended above.

WHEN IS A LOAN A CHARGEABLE LOAN?

Where an applicable company (see introduction) makes any loan or advances any money to a resident individual (including those falling under the Short Term Residence Concession GC 15/03) who is liable to income tax in the Isle of Man and who is-

- a participator in the company; or
- an associate of a participator; or
- an officer of the company; or
- an associate of an officer of the company [s.A108(2)]

The amount loaned is assessed on the company at the higher rate of income tax and is recoverable from the company as if it were an amount of income tax [s.A108(3)]. A company is regarded as making a loan to a person where that person incurs a debt to the company, or a debt due from that person to a third person is assigned to the company. [s.B108(1)]

Section C108 extends the provisions in sections A108 & B108 to apply in the following cases-

- Where arrangements are made by any person (other than in their ordinary course of business) for the company to make a loan or advance which is not otherwise chargeable under section A108(3) and some person other than the company makes a payment or transfers property to (or releases/satisfies a debt of) an individual mentioned in the bullet points above, an assessment under s.A108(3) is made unless the total income of that individual includes an amount not less than the loan or advance made by the company. [s.C108(1)] (This subsection prevents the avoidance of a charge where loans are made through an intermediary or intermediaries).
- Where, instead of the individuals referred to above, a loan or advance is received by a company in a fiduciary or representative capacity, or received by a company not resident in the Isle of Man for the benefit of a resident individual. [s.C108(2)]
- Where a company controls another company, a participator in or officer of the first company is treated as also being a participator in, or officer of, the other company. [s.C108(4)]

In a case where the company is not resident in the Isle of Man, an assessment made on the company under s.A108(3) is payable by the Isle of Man resident borrower on behalf of the company as an income tax debt due by the borrower. [s.C108(3)]

The fact that a loan is interest bearing does not exclude it from charge under these provisions, irrespective of the interest rate.

EXCEPTIONS

Section A108(3) does not apply where -

- The company is an authorised money lender and is carrying on that business, and a loan is made at a normal commercial rate. [s.A108(5)]
- A person incurs a debt to the company for the supply by the company of goods or services in the ordinary course of its trade or business unless the period of credit given exceeds 6 months or is longer than that normally given to the company's customers. [s.B108(2)]
- A loan is made to a full time director or employee of the company, or an associated company, and that person does not have a material interest in the company. [s.B108(3)] A material interest is where a person alone, or with or through associates, owns or has control of more than 5% of the ordinary share capital of the company. [s.B108(7)]

REPAYMENT OF THE LOAN

When a loan which has been assessed on the company is repaid, either in full or in part, the company may make a claim, within 6 years from the end of the year of assessment in which the repayment is made, for the tax assessed thereon under s.A108(3) to be relieved by discharge or repayment [s.B108(5) and (6)]. No repayment supplement is available in respect of any amount charged under s.A108 and subsequently refunded or offset.

Where a dividend is credited to a person's loan account this repayment of the loan will be available for a claim made as above. The dividend will qualify for relief in the normal manner as a deduction from profits. The date of payment used to determine the earliest year of assessment for which relief can be claimed is the date of the loan account credit.

WRITE OFF OR RELEASE OF THE LOAN

Amounts written off/released that have been assessed in accordance with s.A108 are treated as income received by the person to whom the loan or advance was made after deduction of income tax at the higher rate applicable at the time the loan was made. The amount assessed as income is the corresponding gross amount [s.D108(1)]. It is treated as received on the date of write off/release and assessed accordingly.

Where the person has since died, or the loan was made to a trust, the estate or trust will be chargeable.

EXAMPLE	Amount written off year ended 5 April 2007	£50,000
	Add: Notional tax deducted* 50,000 x 18/82 =	£ <u>10,975</u>
	Corresponding gross amount taxable 2006/07	£60,975

The corresponding gross amount will be assessable with a notional Tax Credit of £10,975

[* Loan made January 2005 when the higher rate was 18%]

A notional tax credit will be available in respect of tax deducted by the company but this tax credit is non refundable. There is no provision for reclaim or offset of a section A108 charge when a loan is written off/ released.

Where the debtor is an employee, and section A108 applies, the loan will be charged on the employee as a benefit in kind in the year in which the write off/release occurs. The cash equivalent of the benefit received is the amount of the debt released plus the percentage of that amount equal to the higher rate in force for the year of write off. [ss.D108(3) and 2H(10)]

EXAMPLE	Amount written off year ended 5 April 2006	£50,000
	Add: 2005/06: 50,000 @ 18% (assuming higher rate)	£ <u>9,000</u>
	Benefit in Kind charge for 2005/06	£59,000

It is recognised that the legislation would result in a triple charge where a loan made chargeable under section A108 to an employee who is also a participator is subsequently written off (i.e. charge 1: tax on profits; charge 2: section A108 charge; charge 3: benefit in kind charge). In order to avoid this triple charge the Assessor will allow a notional tax credit to be offset against the benefit in kind charge where a section A108 charge was made. In the example above the notional tax credit allowed would be £9,000. This notional tax credit will not be available for refund.

RETURNS

If during a year of assessment a company -

- a) makes any loan that falls within s.A108; or
- b) receives repayment of such a loan; or
- c) writes off/releases the whole or part of a debt under such a loan,

it is required to return details of the transaction(s) within the annual income tax return. Where a company has an accounting year end other than 5th April that has been accepted as the basis year for the purpose of assessment, the return of loan account movements as required above will be for the same accounting period.

Failure to make a return is an offence. [s.E108(3)]

ASSESSMENT

Following receipt of a return as described above, parts (a) and (b) will be used to calculate an assessment or a repayment, as the case may be. A notice of assessment separate from the company's income tax assessment will be issued to the company for the year of assessment in which the loan movements occurred.

Where the accounting date differs from 5th April (see Returns) the assessment will be for the accounting year ending in the year of assessment.

An assessment made in accordance with these provisions will be payable under the same terms as an assessment to income tax for that year and subject to the same interest provision if paid late. No relief for the amount assessed is available as a deduction from taxable profits.

APPEAL

The charge under section A108 is treated in the same way as a charge to income tax. The appeal procedure is therefore the same as it is for an assessment under section 87 Income Tax Act 1970 with the usual 30 days from the service of the notice.

DE-MINIMIS LIMIT

An assessment made under section A108(3) that does not exceed £100 tax payable will not be issued. Similarly, the general exemption of £400 in aggregate in any year will apply to the benefit in kind charge.

DEFINITIONS

Participant: a person having a share or interest in the capital or income of the company, and includes a shareholder or loan creditor. The statutory definition is contained in section F108.

Associate: includes any relative or partner of the participator, or trustee of a trust where the participator or relative is a settlor, or a co-beneficiary of shares held in trust or forming part of the estate of a deceased person. Certain exceptions apply in the case of trusts. The statutory definition and exceptions are contained in section G108.

Officer: for the purposes of this legislation an officer shall include a person occupying the position of director, manager or secretary.

Director: Includes any person occupying the position of a director by whatever name called. Statutory definition is contained in section H108.

Associated Company: has the same meaning used for the application of the lower rate band for trading companies. Essentially, companies are associated where one of them has control of the other or both are under the control of the same person(s). The statutory definition is contained in section I108.

Loan Creditor: includes a creditor in respect of any debt incurred for any money borrowed or capital assets acquired by the company; and a creditor in respect of any redeemable loan capital issued by the company. The statutory definition is contained in section J108.

Higher Rate: In this practice note, refers to a rate of 18%, being the higher rate at the time of introduction in 2004/05, or to the rate in force for the year of assessment concerned.

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Assessor of Income Tax

This practice note is intended only as a general guide and must be read in conjunction with the appropriate legislation. It does not have any binding force and does not affect a person's right of appeal on points concerning their own liability to income tax.

Comments and suggestions for improvements of issued Practice Notes and suggestions for future Practice Notes are always welcome.