

Directors loan account s.455 charges after an enquiry (Lecture B1417 – 14.06 minutes)

Background

Most business owners are scrupulously honest. However, even for the most honest business owner, tax return adjustments sometimes occur. At the other end of the spectrum, there are dishonest business owners who seek to evade tax by misappropriating the company's income.

In company enquiries, HMRC categorises business profit irregularities as 'non-extractive' or 'extractive'.

Non-extractive adjustments

'Non-extractive' irregularities are understatements of profits (or excess tax relief claims) that do not involve funds being taken out or diverted away from the company. For example, non-extractive amendments to reported profits may arise through private use adjustments (for sole traders or partners), or disallowances due to innocent misunderstandings about complex tax law.

Where a non-extractive understatement of corporation tax has arisen, the company's tax liability is reduced or deferred. HMRC considers this to give the company's owners an unfair advantage over other company owners, on the basis that it increases the company's worth.

Extractive adjustments

'Extractive' irregularities occur broadly where money or value is taken out or diverted from the company by or on behalf of the company's owners. In extractive cases, HMRC might seek a settlement of the evaded tax in various ways, depending on the circumstances.

For example, omitted turnover will generally be charged to corporation tax on the company as additional profits. In addition, a director shareholder who has benefited from receiving the omitted turnover, or from having company funds diverted to them, might have an existing directors' loan account (DLA) with the company. HMRC could propose that the omissions are debited to the individual's DLA. Rewriting the DLA in this way could result in it moving from a credit balance to an overdrawn balance. If so, a close company will also be faced with a potential liability under the 'loans to participators' legislation. If so, the company would generally be chargeable under CTA 2010, s 455 (at a current rate of 33.75%). Furthermore, an income tax liability may arise for the director under the beneficial loan provisions (ITEPA 2003, s 175).

HMRC's view (in its Enquiry Manual, at EM8601) is that where a settlement at the end of an HMRC enquiry concerns extractive adjustments involving the company's directors, the debt incurred by the director in respect of the extractions is not a loan until there is an intention that it be repaid. In other words, a liability under ITEPA 2003, s 175 attaches to the directors in extractive settlements from the date the intention to repay the debt can be shown to exist, until such time as the debt has been repaid. In practice, it would be unusual to find evidence that the company or director agreed at the time the funds were taken, that it would be repaid; an intention to repay will normally occur when the settlement terms are being discussed.

If the director does not have a loan account with the company, HMRC may seek to tax the omitted company turnover as undisclosed employment income instead.

However, in cases where there is little evidence about the misappropriations and the circumstances surrounding them, HMRC's preference is normally to treat money extracted from the company as loans to participators; but the tax treatment will depend on the circumstances.

An HMRC enquiry will eventually be settled by contract or assessment. In terms of the three potential tax charges mentioned in enquiries involving extractive adjustments, (i.e., corporation tax, section 455 and section 175). HMRC will generally address each charging provision separately (EM8610). Interest and penalties will also need to be considered.

If the DLA is being released or written off, the company will normally be able to make a claim for relief from the section 455 charge (under CTA 2010, s 458), and HMRC may allow the relief under a contract settlement, so that there is only interest and penalties to consider in respect of the understatement. However, the director shareholder will normally be liable to an income tax charge on the release or write off (under ITTOIA 2005, s 415).

Recent section 455 cases

In *Gopaul v Revenue and Customs* [2023] UKFTT 728 (TC), the company operated a take-away pizza business, of which the appellant taxpayer was the only shareholder and director. In June 2017, HMRC issued the company with 'best judgement' VAT assessments because HMRC considered that the company's turnover had been systematically suppressed. In addition, HMRC issued the company with a penalty on the basis that the behaviour had been deliberate. HMRC also issued the taxpayer with a personal liability notice (PLN) (under FA 2007, Sch 24, para 19) making him liable for 100% of the penalty on the basis that the inaccuracies were attributable to him. In September 2017, HMRC opened enquiries into the company's tax returns, and subsequently issued closure notices and amended assessments for 2016 and 2017 and discovery assessments for 2014 and 2015. The assessments were made up of: (a) corporation tax on undisclosed profits; and (b) section 455 charges. HMRC had treated omitted company sales as funds misappropriated by the taxpayer and treated them as loans or advances to participators for section 455 purposes. HMRC later issued the company with a penalty representing 56% of the total extra corporation tax, on the basis that the behaviour had been deliberate. HMRC later issued the taxpayer with a PLN for the same amount. The taxpayer appealed, but the First Tier Tribunal (FTT) upheld the VAT, corporation tax and section 455 PLNs.

With regard to penalties, the FTT upheld HMRC's corporation tax penalty, on the basis that the company had acted deliberately in suppressing profits. On the penalty relating to the section 455 liabilities, HMRC needed to prove the taxpayer knew that the company had a liability under section 455 and deliberately omitted it from the company's tax return. However, the FTT found that HMRC had failed to discharge their burden of proof, and allowed that part of the taxpayer's appeal.

In *New Claire Wine Ltd v Revenue and Customs* [2024] UKFTT 00014 (TC), the appellant company was owned by two directors (B and P). The company was VAT registered, and according to P traded "...in the wholesale of wine, beer, spirits and other alcoholic beverages [and] does business with many wholesalers and cash & carry shops". During an enquiry, HMRC identified significant differences between the stock reported in the company's accounts and the figures that should have been held. There were also instances of product lines being sold where no purchase invoices could be found or where they were not included in the opening stock analysis. HMRC subsequently issued: (a) corporation tax and section 455 discovery assessments in October 2019 for the company's accounting periods ended 31 January 2013 to 2017; (b) VAT assessments for the periods ended June 2012 to March 2017; and (c) a penalty notice for deliberate tax return errors. The company appealed.

For section 455 purposes, HMRC considered that the 'Other Creditors' figures in the company's accounts was the two DLAs. HMRC subtracted the additional profits in its stock flow exercise from the closing balance on the DLA at 31 March 2013 to determine the revised balance. HMRC then determined the revised balance in each year, and the balance reported in the accounts was added back to the previous year's revised balance, before the potential additional profits were subtracted. The section 455 charge was then applied to the increase in the level that the DLA was overdrawn in each year.

The FTT accepted HMRC's approach to establishing the quantum of the assessments, which was based on a 'presumption of continuity' (from *Jonas v Bamford* 1973 51 TC), so HMRC's stock flow exercise could be extrapolated to other accounting periods. The tribunal also rejected the company's argument that HMRC's analyses were so flawed that they were unreliable. Furthermore, deposits into the directors' private bank accounts had not been adequately explained or supported by documentary evidence. The tribunal found that the company (through its directors, who diverted funds to themselves) advanced the monies to the directors. Looking at the totality of the evidence, the tribunal found that the company's behaviour was deliberate. The company's appeal was dismissed.

A little knowledge?

The success of the taxpayer's appeal on section 455 penalties in *Gopaul* turned on his knowledge (or rather, his lack of knowledge) about how section 455 liabilities arise. The tribunal commented: "...there is no evidence that Mr Gopaul even knew at the time the returns were made, that the extraction of money from his own company could trigger a corporation tax charge: nothing in the correspondence discusses his knowledge or understanding, and he was not cross-examined on this point. We agree...that HMRC have failed to meet their burden of showing that the Company acted deliberately in omitting the section 455 liabilities from its corporation tax returns."

The tribunal's decision in *Gopaul* offers hope that some taxpayers may be able to escape penalties on section 455 liabilities in appropriate circumstances, although of course *Gopaul* does not set a binding precedent and may be subject to appeal by HMRC.

Contributed by Mark McLaughlin