Director’s Loan accounts

What you need to know

A guide from Complete Accounts Limited

Tel: 01926 855800

Web: completeaccounts.co.uk

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Background

It is important to remember that companies are separate legal entities from their directors and shareholders and it is essential that personal funds/assets are clearly distinguished from funds/assets belonging to companies.

Any transactions between a director/shareholder and their companies will have varying implications and tax treatments and therefore need to be carefully recorded, which is often dealt with via a director's loan account.

Director's loan accounts and how they work

The director's loan account is a company record and it keeps a running balance of the amounts put into or taken out of the company and at any given date this running balance will represent either a loan to the company from the director or a loan from the company to the director.

Examples of amounts put into the company by the director would be:

- undrawn salary – ie processed through the payroll with Tax and NI deductions but not actually paid to the director
- undrawn dividends - ie voted **following Companies Act 2006 procedures** but not physically paid
- money put into the business – ie an injection of funds from an outside source
- expenses paid on behalf of the business
- Interest paid by the director on a loan from the company

All of the above represent loans from the director to the company and are known as CREDITS

Examples of amounts drawn out of the company by the directors are:

- Personal liabilities of the director paid using company funds (e.g. shopping)
- Round sum amounts withdrawn not processed as a salary or as a dividends in accordance with Companies Act 2006
- The repayment of expenses initially paid on behalf of the business (The initial expense paid by the directors is shown as money introduced – see above).

All of the above represent loans to the director from the company and are known as DEBITS

When the balance is, in overall terms, a credit figure, i.e. in net terms the company is holding funds for the director, then this is classed as a loan to the company from the director. When in net terms the director has borrowed funds from the company there will be a debit or overdrawn balance. From time to time balances can move from credit to debit and vice versa.

If the company has more than one director then strictly speaking separate records for each should be kept, although it is usually acceptable for spouses and civil partners to operate joint accounts (again in a similar way to a joint account held at a clearing bank).

Director's loan accounts can be a simple way for both companies and directors to obtain funding without the need to involve a third party. However, it is important to understand the consequences and effects of any transactions undertaken. It is also important that all transactions are correctly recorded as and when undertaken and that directors and their companies are aware of the running balance at all times.

An important note on dividends and salary

Otherwise unpaid salary or dividends can only be credited to a director's loan account at the point at which such remuneration (received in an individual's capacity as a director) or dividends (received in an individual's capacity as a shareholder) is formally voted. The Companies Act 2006 sets out the appropriate procedures but under no circumstances can remuneration or a dividend be said to have been voted at some point in the past, i.e. any credit arising from the voting of remuneration or a dividend can only take place on the date on which the appropriate resolutions are passed which in respect of remuneration would also be the date on which a PAYE/NI liability would be triggered.

This point is becoming increasingly important as HMRC start to take detailed interest in this area.

Credit balances

Where in net terms a director has introduced funds to a company such that the company owes money to that director then generally the consequences are fairly straightforward. Interest may be charged by the director to the company, if desired, at a reasonable rate (perhaps currently up to about 6% p.a.). Any interest payments made must be subject to a 20% tax deduction at source with any higher rate liability collected via the director's self assessment tax return. Interest paid to directors, whilst taxable, can be a useful form of profit extraction as no liability to National Insurance arises. The director of course needs to appreciate that recoverability of the amount due to him/her may be an issue if the company were to fail. In addition, a failure to recover a loan to a (trading) company by a director/shareholder will, for tax purposes, only give rise to a capital loss (and as such will only be available for relief against capital gains rather than the much more valuable relief against income tax available in respect of some other types of loss).

Debit/Overdrawn balances

Loans to directors (overdrawn balances) where in net terms the director/shareholder has withdrawn more funds than to which he/she is entitled results in a debit or overdrawn balance. Strictly speaking any such arrangement (where the overdrawn balance is £10,000 or more) should be formally approved by the shareholders in the company to comply with the requirements of the Companies Act 2006 and overdrawn balances (at whatever level) must be disclosed in the company's annual accounts. Furthermore, if there is an overdrawn balance then the director/shareholder has an obligation to repay the balance at some point, either by introducing funds to the company or from credits which will be due from the company (e.g. dividends) to the director at some point in the future. Difficulties can arise where future credits are anticipated but do not materialise, often as a result of the failure of the company.

Additional tax - Company

Notwithstanding the above, it would be very simple without legislation for a director/shareholder in a private company to arrange for profits to be extracted from the company by way of a long term loan and thus have no personal income tax liability on either a director's bonus or shareholder's dividend.

To prevent this there is a system which in simple terms means that if a loan is taken from a company by a participator (director or shareholder) and is not repaid within 9 months of the end of the accounting period, then the company must make a tax loan to HMRC. The amount is 32.5% of the loan to the director which is not repaid within 9 months. When the loan is eventually repaid by the director, then HMRC will repay the tax loan. However, there is a long time lag in getting the tax loan back from HMRC.

The tax loan comes about from Section 455 Corporation Tax Act 2010 and is often referred to as s455 tax.

Recent changes

Rules regarding the repayment of loans and the recovery of any s455 tax paid changed in March 2013.

The relief for loan repayments is restricted by two new rules:

1 30 days rule.

If amounts totalling £5000 or more are repaid and then drawn out again within 30 days then the tax loan repayment is restricted.

2 £15,000 rule

If immediately before the repayment is made the loan to the director is £15,000 or more, then any further borrowing from the company, at any time in the future, will restrict the repayment of the tax loan.

This rule comes into play when the subsequent new loan is intended or arrangements are in place at the time of the repayment of the original loan.

The impact of these rules is that the company may not recover the entire tax loan until the loan to the directors is permanently repaid or a repayment falling foul of the above rules may be ignored and consequently the 9 month repayment rule may be breached giving rise to the extra 25% tax even though it may appear at first sight that the loan has been repaid. In other words, if the repayment is short term and immediately re borrowed, the loan is treated as continuous.

Note: The restrictions here do not apply to repayments that give rise to an income tax liability on the director e.g. salary, dividends credited to the loan account etc.

Future developments

The above rules are under review and some commentators feel that there will be a permanent tax introduced to replace the tax loan system outlined above.

Additional tax - Director

Overdrawn director's loans can also give rise to tax charges under Section 175 ITEPA 2003 relative to the benefit-in-kind of having a cheap (i.e. currently where the company charges less than 4% on any funds advanced) or interest free loan. Small loans (i.e. those of £5,000 or less –£10,000 from April 2014) are ignored for this purpose but (almost) all other loans must be disclosed and a benefit-in-kind calculated thereon (currently at a notional interest rate of 4%) and declared on form P11D. Failure to declare this benefit on form P11D is a common error and if identified via a PAYE audit or review of the company's corporation tax return could well be the starting point for a wider investigation of the affairs of the company and its directors/shareholders. As well as producing a personal income tax liability for the director the P11D entry produces a liability to Class 1A National Insurance for the company. (Note that the liability to personal income tax and company Class 1A national Insurance arises independently of the company liability under Section 455 – see above. A personal income tax liability and company Class 1A liability arises for each and every day there is an overdrawn balance and it continues until the loan is repaid. Unlike the Section 455 charge which is cancelled and refunded once the loan is repaid, the personal income tax charge and company Class 1A liability once incurred become a permanent cost).

One way sometimes suggested to deal with overdrawn loan account balances is for the company to forgive the balance due, i.e. agree to write it off as some sort of bad debt. Such a course of action may be prohibited by the provisions of the Companies Act 2006 (especially when the company does not have sufficient profits to cover the amount involved) and this again may well cause difficulties if the company were to fail. In addition the beneficiary of any such treatment is treated as if they have received a dividend and the company is specifically denied any relief for corporation tax purposes. Furthermore HM Revenue & Customs are likely to contend that Class 1 (i.e. both employer and employee contributions) national insurance contributions are due since where a loan balance is forgiven in respect of a director/shareholder it is potentially chargeable to income tax, both as if it were a dividend and an employment benefit-in-kind. The legislation dictates that, for tax purposes, the dividend charge takes precedence, however, this rule has no relevance to any charge for national insurance which is therefore likely to be pursued by HMRC on the basis that the release of the loan is earnings from employment. This approach was used successfully by HMRC in the 2011 Tax Tribunal case of Stewart Fraser Limited.

Personal tax liability for director

It is often felt that in circumstances where the above tax charges are not paid because the company goes into liquidation; the tax will not have to be paid.

There are increasing challenges to this point of view and there are circumstances when the director can be held personally responsible for the taxes.

Next steps

If you have concerns over a problem with a loan to a participator from a company then seek specific advice from Complete Accounts Limited on how to resolve the issue.

Disclaimer

This article is not intended as a substitute for specific detailed advice and should not acted upon without first taking specific advice from Complete Accounts Limited on 01926 855800.