Directors’ loan accounts

Introduction

When we are asked to scrutinise the accounts of a company, whether for reasons of valuation, professional negligence, or following the failure of a business, directors’ loan accounts frequently pop up. In this article, we briefly summarise the background and some of the consequences of this oft-misunderstood concept.

Background

In broad terms, businesses in the UK generally comprise sole traders, partnerships and companies. Sole traders and partnerships have one thing in common; they are unincorporated. This means that the profits are treated as the owner’s or partner’s income, and subject to income tax thereon. A company, by contrast, is separate from its owners (the shareholders), and its profits are subject to corporation tax.

For many small- and medium-sized businesses, the shareholders are also the directors, in effect, the businesses are “owner managed”. In these circumstances a director/owner is able to take remuneration from the company in a number of ways and so can manage his remuneration tax-efficiently – perhaps taking it partly as salary, and partly as dividends. This can ensure optimum benefit from personal allowances and marginal tax rates, and also minimise the amount of National Insurance payable (by both the company and the director-shareholder).

Unlike a sole trader or partnership, a company is a separate legal entity. Consequently, the money earned by the business belongs to the company and not the directors. Nevertheless, controlling directors often withdraw cash from the company (akin to “drawings” made by a sole trader or partner); they perhaps need cash to fund their day-to-day living expenses, but would prefer not to receive a significant salary due to the adverse income tax and National Insurance implications. On other occasions, maybe for reasons of practicality, the company will meet the personal bills or expenses of its directors. These draw-downs are commonly operated through what is referred to as a directors’ loan account (or “DLA”).

As this withdrawal represents a “loan”, then no tax is immediately payable. Nevertheless, the draw-down will create a liability from the director to the company. Usually a liability that arises will later be eliminated when the company declares a dividend to the director (and it is this dividend that triggers a tax charge to the director).

As an illustration, let us consider the hypothetical example of Branson, a shareholder-director of a company. The company pays Branson a modest salary of £10,000 per annum. This falls within the current personal allowance, and hence no income tax is payable on this salary; he will also pay only limited national insurance. However, this isn't sufficient to fund his lifestyle, so he draws down a further £2,000 each month from his DLA. At the end of each quarter, the company declares a dividend of £6,000 to Branson, clearing the DLA. Assuming that he has no other sources of income, the dividend will attract income tax at the lower rate of 10%. Branson's total remuneration from the company is £34,000 per annum.

Tax implications

There are some tax issues to watch out for here:

- A taxable benefit will arise if the total balance of the loan to the director exceeds £10,000 (£5,000 before 6 April 2014). The benefit in kind is calculated as the difference between the interest actually charged (if any) and the interest that would have been charged applying the Revenue's "official rate of interest" (currently 3.25%). Also, as a benefit-in-kind, the loan would attract Class 1A Employers' National Insurance contributions.

- Moreover, if the loan is still outstanding after nine months from the end of the company's accounting reference period, then ordinarily the whole balance of the loan will be subject to a 25% corporation tax charge. This is referred to as "s455 tax" (after the relevant section of the Companies Act), and when the loan is repaid, the tax can be reclaimed by the company.

DLAs in the event of financial distress

Also, be mindful that, under the requirements of the Companies Acts, dividends can only be declared by a company if there are sufficient cash resources and distributable profits available. A difficulty arises if it is only possible to establish definitively whether a company has sufficient retained earnings at the end of the year, say when the statutory accounts are prepared. Any dividends paid that are paid which exceed distributable reserves (i.e. the difference between the permissible level of dividends and the actual dividends paid) are treated as a loan by the company to the director.

When companies face insolvency in around 75% of cases there will be a director with an overdrawn DLA. This arises because it is not uncommon for directors to draw-down company funds with the view to paying them back from later profits only to then struggle to do so when trading takes a turn for the worse.

On insolvency, the liquidators will seek to recover as many of the assets of the company as possible – including overdrawn DLAs. This could well place financial strain on the director, in some cases leading to bankruptcy. Of course, the liquidators will look at all the circumstances of the overdrawn DLA, and perhaps review activity on the account over the two or three years preceding the failure of the business. They will be assessing whether the director has adopted a reasonable approach during that period, including consideration of preference payments and whether the company continued to trade whilst insolvent. Good record-keeping can be crucial here. If the director is unable to repay the entire overdrawn DLA, then the liquidators might reach a settlement if they believe the director has acted in good faith. However, if the director has used the company as a personal bank account – this sometimes arises as owner-directors fail to distinguish between their individual finances and the finances of the company – it is possible that the DLA has spun out of control, the liability has become significant, and the liquidator will seek repayment in full.

On the flipside, it is of course possible that a DLA is not overdrawn (i.e. a liability from the director to the company); if the director lends money to the company, then he may have a DLA that is in credit. However, as you will imagine, these very rarely give rise to problems.