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Contractor and Small Business Specialists

A Contractor's Guide to Director's Loans

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There may be times where you need to borrow money from your own limited company, or you may have unintentionally done so whilst drawing down funds.

What are the tax implications?

There are 3 taxes to consider:

- benefit in kind on the directors loan (PAYE)
- additional corporation tax charges (a S455 charge) on the overdrawn loan
- self-assessment, potential higher rate tax on dividend

Personal Tax Considerations and a Beneficial Loan - When it Arises

There will be a benefit in kind whenever an employer (i.e. your limited company) makes a loan to a director or employee or a relative of a director or employee and that loan is made interest free.

The meaning of relative

The term relative is defined very broadly. An individual's relative is any sibling, parent, child or a remoter ancestor or linear descendant of the individual. It then includes the spouse of such a person, as well as the individual's own spouse and any brother or sister of the Individual's spouse. The legislation also applies in the same way for civil partners as for spouses.

The meaning of loan

A loan in this context means any form of credit and the making of a loan includes arranging, guaranteeing or in any way facilitating a loan, so it's not actually necessary that the loan funding comes from the employer; merely that the employer was involved in the process in one of these ways.

Official rate of interest

A benefit can only arise where the amount of interest paid on the loan is less than HMRC's official rate. The Taxman's official rate of interest has now been 2.5% since 2019.

Interest paid

In order to avoid the loan benefit, it is generally as well to pay interest equivalent to the official rate of interest. The loan interest will be taxable income in the company but can then be extracted as a dividend. In most circumstances this gives a better overall result. HMRC will not regard the interest as having been paid if it is simply added on to the loan ccount, the interest has to be paid.

Beneficial loan exclusions

De minimis threshold
Director's loans under £10,000 have since 2014/15 not attracted a benefit in kind charge. You have to aggregate all loans and look at the position across the entire tax year. If there's any point in the tax year at which the aggregate of outstanding loans exceeded the threshold, then all loans are subject to a benefit.

Ordinary commercial loans and fixed rate loans.
An ordinary commercial loan broadly means that similar loans must have been made to ordinary members of the public on the same terms at around the same time by a commercial lender

Expense advances.
For a genuine expense advance of no more than £1,000 there is no benefit in kind. To qualify though the advance must be spent within six months and the employee must regularly account to the employer for the expenses incurred.

Beneficial loans calculation

If we've established that loans do exceed the de minimis threshold and aren't excluded from a benefit in kind charge, we then need to calculate the benefit in kind. This is done by calculating what the interest on the loan would be at the official rate, using one of the two methods set out below, and then deducting the amount of interest that was actually paid.

Averaging method (default)

The normal method for calculating the interest on a loan at the official rate is what is called the averaging method.

The average loan balance during the tax year is first calculated by taking the balance when the loan was first made (or at April 6 if the loan was made in a previous tax year) and the balance immediately before the loan is fully repaid (or at April 5 if it isn't fully repaid in the tax year). The two amounts are then added together and divided by two to give the average loan balance. This will be A in the formula below.

It is also necessary to calculate the number of complete tax months (beginning on the 6th of each month and ending on the 5th) that the loan was in existence. This will be M in the formula below.

Interest at the official rate is then calculated by the formula A x I x M /12, where I is the applicable official rate of interest.

This is illustrated in the following example.

Example

Paul's employer made him a loan of £12,000 on May 11 2019. Paul made a number of repayments and received a number of additional advances and the balance on the loan was £1,000 on March 4 2020 when Paul fully repaid the loan.

The average balance on the loan was £6,500 ((£12,000 + £1,000)/2) and it was outstanding for the following 8 complete tax months:

- **June 6 to July 5**
- **July 6 to August 5**
- **August 6 to September 5**
- **September 6 to October 5**
- **October 6 to November 5**
- **November 6 to December 5**
- **December 6 to January 5**
- **January 6 to February 5**

Whilst the loan was outstanding for a period of nearly 10 months, the periods May 11 to June 5 and February 6 to March 4 are not complete tax months, and so aren't counted.

The official rate of interest for 2019/20 is 2.5%, so interest at the official rate on the loan is £108 (£6,500 x 2.5% x8/12).

If Paul has paid no interest at all on the loan, this will also be the benefit in kind amount.

Actual method

The default averaging method can give rise to a figure that is advantageous or disadvantageous, dependent on the precise movements on a loan. As a result of this, the legislation permits either HMRC or the employee to elect for an actual basis of calculation, whereby an interest rate of 1/365th (1/366th in a leap year) of the official interest rate is applied to the balance outstanding on the loan each day. The amounts from each day are then aggregated to produce the amount of interest on the loan at the official rate.

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Company Tax Charge

Where a company makes a loan to an individual who is a director of the company there is a corporation tax charge on the company in respect of the loan. The tax paid becomes repayable as and when the loan is repaid or written off.

The tax charge

The corporation charge is 32.5% for loans made on or after 6 April 2016. Prior to that date the tax charge was 25%.

The charge is based on the amount of loans advanced in the period. It will be payable along with the rest of the company's corporation tax liability, nine months and one day after the end of the accounting period.

Repayments

When the loan is repaid the tax that was paid or payable in respect of the loan will become repayable.

If the repayment occurs before the payment of the tax in respect of the advance is due, i.e. within nine months and one day of the end of the accounting period, the repayment becomes due at the same time as the tax on the advance is due, meaning that there is no net payment to be made.

Where the repayment occurs more than nine months and one day after the end of the period in which the advance was made, the repayment will not become due until the time when the tax is payable for the period in which the repayment occurred.

Example

Brian's company (100% owned) has made a loan to him of £100,000 in its period ended March 31 2019.

By December 31 2019 the balance stood at £40,000 and at March 31 2020 the balance is only £20,000.

£60,000 of the loan has been repaid within nine months and so the company's tax charge, in respect of the loan, payable on January 1 2017 is only £13,000 (£40,000 x 32.5%).

Because a further £20,000 has been repaid in the 2020, the company will be entitled to claim further relief of £6,500 (£20,000 x 32.5%), with efect from January 1 2020.

Loans Written Off

If a loan that is (or would be) subject to the above corporation tax charge is written off, the same effects ensue as for a repayment.

If the write off occurs within nine months and a day of the end of the period in which the advance was made, the repayment has the same timing as the payment of the tax, such that no net tax is payable.

If the write off occurs later, the repayment is given effect on the date that the tax payment is due for the period in which the write off occurred. At the point of write off, the amount written off becomes taxable on the participator, i.e the director concerned, as a dividend.

This dividend tax charge overrides the general tax charge that arises on a beneficial loan. HMRC also argues that national insurance is still due on the amount written off as earnings.

Company Tax Charge - New Bed and Breakfasting Rules

Rules have been introduced in relation to repayments made on or after March 20 2013 to prevent what was known as bed and breakfasting of repayments; where a repayment is made and then the amount is redrawn at a later stage.

The thirty day rule

Where within a period of thirty days there are both:

- repayments totalling £5,000 or more, and
- amounts drawn totalling £5,000 or more,

the repayments are set against the amounts drawn in priority to any other part of the loan, subject to the one exception mentioned below.

The arrangements rule

Where:

- there is a loan balance of at least £15,000,
- an amount (by definition of at least £5,000) is repaid from that balance, and
- there are arrangements in place for at least £5,000 of the amount repaid to be re-withdrawn later

the repayment is set against the arranged later drawing in priority to any other part of the loan, subject to the one exception mentioned below.

Exception to the rules

Neither of the above rules apply in relation to a repayment that gives rise to an income tax charge for the director. So the rules will not apply in relation to repayments made by dividend, salary or some other taxable amount.

Practicalities

In determining what effect is to be given to repayments, year end balances and balances at the nine month point will need to be adjusted for these rules, where repayments are made by non-taxable means.

Example

Dan's company lent him £10,000 during its period to March 31 2020. On December 30 2020 he repaid £5,000 so that the balance was only £5,000.

On January 28 2020 (within 30 days of the repayment) Dan draws another £5,000.

The £5,000 repayment on December 30 2020 is matched with the £5,000 drawn on January 28 2021, and so the balance on which tax must be accounted for remans £10,000. Tax of £3,250 will be payable on January 1 2021.

Director's Loans can be Complicated

There are a lot of details to consider and getting them wrong can be expensive. If you're still unsure or if you need advice please contact Orange Genie Accountancy today.

One of our friendly and experienced accountants would love to help you.

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