Directors' loan accounts – avoiding the risks

Introduction

HMRC produce a series of toolkits which set out common errors that they find in returns. The hope is that by being familiar with the mistakes that are routinely made, steps can be taken to avoid them. Although the toolkits are aimed primarily at agents, they are useful for anyone who has to complete a tax return. The directors' loan accounts toolkit highlights the key areas of risk in relation to directors' loan accounts. The latest version of the toolkit was published in May 2019 and should be used for personal tax returns for 2018/19 and for company returns, for the financial year 2018.

Personal expenses

Expenses are only deductible in computing taxable profits to the extent that they are incurred wholly and exclusively for the purposes of the trade. A company is a separate legal entity to the directors and shareholders. However, many close companies meet directors' personal expenses. Where these are not part of the director's remuneration package, the company cannot deduct the cost when computing its taxable profits. Instead, they should be charged to the director's loan account. The director's loan account toolkit focuses on expenses that do not form part of the director's remuneration package.

Risk areas

1. Review of the accounts - any personal expenditure incurred by the director and paid for by the company must be allocated correctly, i.e. an allowable expense where it forms part of the director's remuneration package and charged to the director's loan account. Account headings should be reviewed to identify director's personal expenditure which has not been treated correctly.

2. Loans to participators – under the close company rules, tax (section 455 tax) is charged at 32.5% on loans to directors who are also shareholders where the loan remains outstanding nine months and one day after the end of the accounting period. Review overdrawn loan accounts to check whether the company is liable to pay section 455 tax.

3. Review of expenses and benefits – where a director is provided with anything other than pay, it may need to be reported to HMRC as a benefit in kind on form P11D. Review expenses and benefits for taxable items that may have been missed. It should be noted that if the director's loan account balance exceeds £10,000 at any point in the tax year, a benefit in kind charge will arise on the loan unless the director pays interest at a rate that is at least equal to the official rate (2.5% since 6 April 2017).

4. Self-assessment – check whether the director needs to send a self-assessment return. The directors' loan accounts toolkit

states that “Company directors do not need to send a tax return unless that have other taxable income that needs to be reported, or if HMRC has sent a notice to file a return”.

5. Record keeping – good keeping is essential. Poor records may mean expenditure is missed or allocated incorrectly.

Checklist

The toolkit features as useful checklist which can be completed to make sure that nothing is overlooked. The checklist contains a helpful link to HMRC guidance.

Recommendation

Carefully review your directors loan account each year to ensure it is complete and accurate. The treatment of personal expenses within a company is high on HMRC agenda for enquires so care should be taken.

Remember, the benefit in kind in relation to interest free directors loan accounts runs to the year ended 5 April each year. Many companies do not have a coterminous year end with this date, so it is important your company’s records are update to date and accurate during the year. Don’t wait for your company year end to review and make appropriate adjustments as you may have already submitted and reported to HMRC with your P11d returns.

It is important to have a clear strategy in dealing with directors’ loan accounts to avoid any nasty surprises.

If you have any further questions or concerns, please contact me.

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