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Director-shareholders and loan transactions

This briefing details the tax issues that surround loans to director-shareholders and loans from director-shareholders to their companies. There has been an increase in the rate of tax on loans to 'participators' from 6 April 2016 which means it will be more costly for the company to make such loans. Changes to the personal tax regime from 6 April 2016 have meant that the receipt of interest by shareholders on loans they have made to their companies may be an attractive means of distributing some of the profits of the company.

Loans from the company

What are the tax issues for the company?

If a close company makes a loan to a participator (for example most shareholders in unquoted companies), the company must make a payment to HMRC if the loan is not repaid within nine months of the end of the accounting period. The amount of the corporation tax, often referred to as s455 tax, is 32.5% of the loan if the loan is made on or after 6 April 2016. For loans made before this date the s455 tax is 25%.

This tax is included within the corporate tax self assessment system and the company must report loans outstanding to participators at the year end in the company tax return.

If the loan is repaid after the company has paid over the s455 tax, the tax will be repaid but not until nine months and one day after the end of that accounting period in which it is repaid. So the company will need to pay over the tax and wait some time for it to be repaid.

A loan includes advances, such as a current account that many shareholders may have with the company when the shareholder is also a director of the company. A loan to an 'associate' of a shareholder, such as a relative, is also included as if the loan had been made to the shareholder.

Example
A company has a 31 December year end. A loan made to a shareholder in the 2016 accounting period (and after 6 April 2016) was not repaid by 1 October 2017. The company must pay s455 tax by 1 October 2017. If the loan is repaid in, say, 2018 the tax relating to that loan would not be due for repayment until 1 October 2019.

Tax issues for the director-shareholder

The making of the loan may have tax consequences for the shareholder who is also a director of the company. An income tax charge will arise if the interest paid on the loan (if any) is less than the interest at the official rate. In most cases, National Insurance Contributions (NICs) (Class 1A) will be due from the company on the benefit assessable on the director.

So why can't we simply pay off the old loan and take out a new loan a few days later?

A shareholder may organise his finances such that he repays a loan or advance made by the company to him just before the end of the nine month period so no tax charge arises on the company. Shortly afterwards the company provides another loan to the shareholder. In substance the shareholder has continual use of the money from the company but the company does not suffer the s455 tax that would otherwise arise.

HMRC had been concerned about this and other arrangements for some time. In order to ensure that such arrangements do not work, new tax law was introduced in 2013.

There are two main rules.

The first is a 30 day rule. This applies for loans of £5,000 or more. If at least £5,000 is repaid to the company and within 30 days new loans or advances of £5,000 or more are made to the shareholder (or an associate), the old loan is effectively treated as if it has not been repaid. As a consequence s455 tax may become due.

The second is an arrangements rule. The first rule could be avoided by waiting 31 days before the company advances further funds to the shareholder. The second rule applies where:

- the outstanding amount from the shareholder is £15,000 or more
- at the time the loan is repaid by the shareholder, arrangements had been made to make a new withdrawal with the effect of replacing some or all of the amount repaid, and
- a new payment is made to the shareholder or an associate under the arrangements of £5,000 or more.

The effect where the rule applies is that either s455 tax is still due or any repayment of s455 tax will be restricted by 32.5% of the lower of the amount repaid and the new payment.

Example
Omega Ltd lends a shareholder £20,000 which is still outstanding at the end of the accounting period. 35 days before the s455 tax becomes due and payable, the shareholder receives a further £25,000 payment from the company. The original £20,000 is repaid using £20,000 of the £25,000 new loan. It is likely in this situation that the repayment of £20,000 would be treated as a repayment of £20,000 of the new £25,000 loan. The original loan would therefore be treated as not repaid and so the s455 tax would become due and payable.

What should be done by the company and shareholder so that the s455 tax does not arise?

If loans or advances on a current account are made to a shareholder, the amounts need to be cleared within nine months of the accounting period in which these amounts arose. This can be achieved by:

- the shareholder repaying the loan by making a payment in cash. However, if further amounts are subsequently borrowed from the company, HMRC may be able to apply the rules which treat the old loan as not repaid, or
- the company declaring a dividend or granting a bonus which is equal to the amount outstanding. The dividend or bonus will remove the s455 tax liability as these amounts are chargeable to income tax in the hands of the shareholder.

Example
Bernard is the sole shareholder and director of Extra Ltd. His current account with the company increases about £2,000 a month so that by the end of the company's accounting period which ends on 31 December 2016, he owes the company £24,000. The current account continues to increase by £2,000 a month in 2017. In June 2017 a dividend is declared which is £24,000. Under general principles of law, loans are treated as being repaid first unless another order is agreed. The accumulated current account balance at 31 December 2016 is therefore treated as cleared by the dividend and thus no s455 tax is due from the company on 1 October 2017.

It is essential however that the amounts are cleared properly and, in the case of a dividend, in compliance with company law. This is where we can help you to ensure that s455 tax is not payable.

Loan releases

If the company decides to release the shareholder from repaying the loan the shareholder is assessed on the income as dividend income, as opposed to earned income. The effective tax rates are therefore the same as if a dividend had been paid to the shareholder.

Although from a tax viewpoint the income is not assessed as earned income, HMRC generally consider the dividend to be subject to Class 1 employer and employee NICs if the individual is a director or employee of the company.

The impact of NICs means that it is preferable to pay a real dividend to enable the loan to be cleared. There are some other points to consider so please talk to us before a decision is made.

For the company, a release of the loan will be treated as if the shareholder has repaid the loan and thus the company will be entitled to a repayment of any s455 tax paid.

Loans to the company

If the company is in need of additional funds the shareholder may wish to lend money to the company. Recent changes to the personal tax regime in the taxation of interest receipts have the potential to give personal tax savings where interest is charged on such loans.

Interest charged at a commercial rate will generally be tax deductible for the company.

In the hands of the shareholder, the income will be taxable as savings income. No NICs will be due even if the shareholder is a director as NICs only apply to earned income. This will benefit both employer and employee.

There are two tax breaks which can apply to savings income. One is new for the 2016/17 tax year – the Savings Allowance. The practical effect of the Savings Allowance is to provide up to £200 of tax saving for basic rate and higher rate taxpayers.

The other tax break on savings income – the starting rate of tax on savings income – was significantly enhanced for 2015/16 and later tax years. This tax break is potentially worth £1,000 as it taxes £5,000 income at 0% rather than 20%. This rate is not available if 'taxable non-savings income' (broadly earnings, pensions, trading profits and property income after deduction of the personal allowance) exceeds the starting rate limit of £5,000. But dividends are taxed after savings income and thus are not included in the individual's 'taxable non-savings income'.

Example
In 2016/17 Mrs Beaton is a director-shareholder taking a salary of £11,000 from the company and has no other non-savings income. She receives £7,000 of interest from the company and the balance of her profit share will be taken as dividends. £5,000 of interest will be taxed at 0%. The Savings Allowance will tax another £1,000 (or £500 if she is a higher rate taxpayer) at 0%.

What if the shareholder is taking on personal loans to on-lend to the company?

There are a number of reasons that such a route is taken rather than the company being directly provided with finance from a bank. The shareholder in this instance needs to ensure that:

- interest relief is available to the individual on the interest which depends on certain qualifying conditions, the detail of which we can advise you on
- relief will be available for any capital loss suffered if the company is unable to repay the loan from the shareholder.

The main points to appreciate here are:

- the finance received by the individual is a loan rather than an overdraft or use of a credit card
- interest relief is given as a deduction from total income of the individual. This may give more tax relief than the amount of tax on the interest received from the company. However where there is a very large amount of interest paid there may be restrictions on the amount of interest that can be deducted from income
- the company uses the monies from the loan from the individual for the purposes of its trade.

In some cases, it may be preferable to invest the monies as further share capital rather than as a loan.

How we can help

Please talk to us if you are considering obtaining a loan from your company or providing further finance to the company. We can then advise on the effects of the transaction in good time.

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