Directors Loans and how NOT to use them

Mark Kingston: Hi and welcome, my name is Mark Kingston and I am really delighted to be joined again by Matt Williams, one of the partners in our business team here at Critchleys

Matt Williams: Hi, it's good to be here

Mark Kingston: Last time we talked about electric cars and diesel cars and twin cab pickup, today we are going to talk about something completely different, what's a director's loan account and how NOT to use them

Matt Williams: Indeed.

Mark Kingston: Important distinction...

Matt Williams: Absolutely

Mark Kingston: Let's start with that, first of all Matt. What is a director's loan account?

Matt Williams: That is a question I get asked a lot, especially from clients that are fairly new in business or people that have incorporated what was a sole-trader or partnership business, so they have entered this corporate structure and then one of the first conversations they might have with their accountant is, "oh look you have got an overdrawn directors loan account and these are the implications of that". And it is important that if you are operating your business though a corporate structure that you understand the distinction between the companies money and your money as an individual, and often, like you are Mark a small business that is 100% owner managed, that line is quite blurred, if you own the business 100% surely the money in that business is yours

Mark Kingston: But is not quite that straight forward.

Matt Williams: Unfortunately it is not, and that is where people get into trouble with these directors loan accounts, and that is where we try and educate our clients at the start of our relationship with them so that they understand the implications and then can work within the boundaries.

Mark Kingston: So, before we get into the implications for good and for bad, just explain, not in legal terms but in structural terms, what is a director's loan, because we see that on our accounts, but maybe we don't understand the idea

Matt Williams: Effectively what it is, is an account within the accounting records which tracks the balance either owed to or owed from a director of the company. So if you imagine a small business which has started up, generally the owner of that business would need to put in amount of funds to get its working capital up so that it can start off trading, so they might put £15,000 in, and that would go in generally as a director's loan.

Mark Kingston: Because it is not money that the company has earned it is money that the company has effectively been loans by the director,

Matt Williams: Absolutely, and therefore as it goes on to earn profits and has funds available it can repay that loan to the director.

Mark Kingston: So that's an incidents of a positive director's loan, if you will. Can it go the other way round?

Matt Williams: It can indeed. And that's where people run into trouble. So imagine that same business owner, that has put £15,000 in, about 4 or 5 years on they may have repaid that loan...

Mark Kingston: So the business has paid the £15,000 back, let's say the account now is at zero

Matt Williams: Absolutely.

Mark Kingston: So the business doesn't owe the business owner money and the business owner doesn't owe the company money. How might that change?

Matt Williams: To use an example which I know is close to heart at the moment, imagine if the director has just crashed their private car

Mark Kingston: Thanks for that Matt, it is still a source of great pain.

Matt Williams: So they have got to pay an amount for the private asset and they for one reason or another pay that out of that company we would then as accountants come along at the end and say that what that £150 for

Mark Kingston: So I scraped my car which did happen sadly, it is a private car, I was on company business when I was driving, let say, what you are saying if I then decided to go and pay my insurance excess and thought because I was on company business I can use a company card to pay it, and therefore it came out of the company, what you are staying is you would then look at my accounts and say no you can't do that. Why couldn't I have done that?

Matt Williams: Because it is not a wholly exclusive business expense, you needed to repaired that car

Mark Kingston: Because it is a private car, and I was claiming the mileage on that car, and that is the allowance I am given, and I couldn't go above that. OK

Matt Williams: Yes. So we would then take that to your loan account which would mean at the end of your year, if nothing else had happened your directors loan account would be overdrawn by £150.

Mark Kingston: Now that's not a practically big deal, but I can see how if larger sums are involved it could quite quickly become a big deal, practically if you haven't got this distinction between what is the company's money and what is your money clear in your mind

Matt Williams: Indeed, and if you are a small business that is struggling for cash one way or the other, so there isn't the funds in place to pay dividends out or a regular salary, that line gets blurred very quickly and so we have lots of cases where business owners are just using the company bank account to cover household bills and bits and pieces like that, so the overdrawn directors loan account could build up quite quickly and the implications of that are at the year end, if the that overdrawn directors loan account isn't repaid within nine months of the year end, then there is a tax charge on that under Section 455 which is of 25% of that balance, so if you have got a £5,000 overdrawn directors loan account, you can see there is fairly chunky tax change that gets added on

Mark Kingston: To me personally or to the business?

Matt Williams: The Company pays it. And once that loan comes back into a positive situation, that amount of Section 455 tax is re-payable from HMRC

Mark Kingston: So it can be reclaimed

Matt Williams: So it is not dead money, but is there as an incentive

Mark Kingston: But if you are in a situation where you cash flow is tight then having that extra bill to pay without you expecting could be quite a big deal

Matt Williams: Absolutely, and it might be a case that if cash is tight and you are not actually making any money, you might not be expecting to pay any corporation tax because you haven't made any profits, but you could still end up having to pay this Section 455 tax

Mark Kingston: Ok, so let me recap, there is a distinction and our very first pod cast actually was with Gerry Jackson, our senior tax partner and he was making the case that sometimes it is good to incorporate and become a limited company, there are other times which it is either remain as a sole trader or a partnership or even become one, and I can see where if you are at the start-up of your business journey or you are quite a small business that you could get confused between the idea that the company is something other than you and therefore the company has its money and you have your money. So to be clear to our listeners what I hear you saying is things like salary, dividends, those things are my money that the company is paying me.

Matt Williams: Absolutely, and then you can do what you want with it

Mark Kingston: Whereas there are times when I might take money out of the company to pay for something with consideration or accidently, because that happens does it, as you were saying, when actually even though the money has come into my personal account it is still in tax terms deemed to be the company's money and therefore it has a whole different tax implication and legal implications in terms of where the money is and where it can go, and how much it will cost

Matt Williams: Absolutely, and there is two other things we should probably make sure that we cover in this pod cast. The first is if the overdrawn directors loan is over £10,000 then you fall into the benefit in kind regimen, so there could be some further tax implications and that's on you as an individual, so that is certainly something to think about, and also if the business is struggling and the directors loan account is overdrawn and then you end up in a liquidation scenario so the business becomes insolvent, it can't pay its debt as they become due, and either you are forced into administration or you come to a decision that you have to put into liquidation yourself, then having a overdrawn directors loan account could have come significant implications on the director because any liquidator would see that overdrawn directors loan account as an asset on the balance sheet,

Mark Kingston: Which they want to get as much back as possible

Matt Williams: Absolutely, to pay off the other creditors and so, you know, worst case, if you are the most significant debtor to the company they could apply to have you struck off as a director, they can come after your personal assets, the bankruptcy, you know that is very much worst case, but it is something to consider, and it is easy to get into a spiral where the loan account is £2,000 in year one and £6,000 in year two and by the time we get to year 4 or 5 it is £30/40,000 overdrawn and the business is not going to able to trade its way out.

Mark Kingston: So I would take two points from this Matt, as a business owner myself, the first would be that it is actually really important to have a remuneration plan in place,

Matt Williams: Absolutely,

Mark Kingston: And that is something that an accountant can guide you on

Matt Williams: Well we try and do that with all of our small business client, to try and educate them on this distention on day one, generally, that is day one with us, but it could be their day one in business if they are a start-up, to make sure they understand

Mark Kingston: So helping us answer this question, how much can this business afford to pay me Is a big one. And the second point is that as and when it goes wrong it is really import and to get good advice because that good advice can be the difference between quite an easy resolution or a very painful and expensive one.

Matt Williams: Absolutely, and that is where my college Lawrence King who runs our business recovery and insolvency team, that's where he is a very useful asset to us as a firm to be able to talk to our clients about things like that

Mark Kingston: Matt, as time would have it is 9 and half minutes, the theme music is coming soon, thank you for popping in and demystifying this little bit, we will put some of this in the show notes as well and of course people are always welcome to contract you if they want to on anything of this further

Matt Williams: Absolutely indeed, see you soon