

Taking the credit

Mark McLaughlin looks at the timing of receipts to directors' loan accounts for the purposes of establishing the potential liability to tax and National Insurance contributions

An HMRC enquiry into the tax affairs of a family or owner-managed company will often involve some scrutiny of directors' loan accounts (DLAs). HMRC recognises that DLAs are a potentially lucrative source of additional revenue under the 'loans to participators' provisions (CTA 2010, Pt 10, Chs 3-3B) and possibly as a benefit-in-kind on the director if a loan account is (or has been) overdrawn (ITEPA 2003, s 175).

HMRC will commonly ask for a detailed analysis of the DLA, showing the dates of debits and credits. Aside from the additional tax liabilities mentioned above, a DLA analysis may reveal (for example) failure to notify liability to a charge under CTA 2010, s 455, 'bed and breakfasting' transactions, or failure by the company to apply PAYE at the correct time to bonuses credited to the DLA.

HMRC may issue an information notice if the DLA is not fully itemised and in chronological order and impose penalties for non-compliance. For example, in *Matharu Delivery Service Ltd v Revenue and Customs* [2019] UKFTT 553 (TC) the First-tier Tribunal (FTT) considered that where HMRC enquire into the tax affairs of a sole shareholder and their company, information about the nature, size and timing of payments between the company and the individual were 'reasonably required' by HMRC.

DLA credits

Establishing the proper timing of credits to the DLA is an important exercise from a tax perspective. The most common types of DLA credits are earnings and dividends to the director shareholders.

Earnings

The relevant tax legislation determines that cash earnings are treated as having been received at the earliest of the following (ITEPA 2003, s 18(1)):

- When payment is made of (or on account of) the earnings;
- When the person becomes entitled to payment of (or on account of) the earnings;
- If the employee is a director at any time in the tax year and the earnings are from employment with the company, the earliest of:
 - When sums on account of the earnings are credited in the company's accounts or records (regardless of whether there is any restriction on the right of withdrawal);
 - If the earnings for a period are determined by the end of that period, when the period ends;
 - If the earnings for a period are not determined until after the period has ended, when the amount is determined.

There are different, but broadly similar, rules to determine when a payment of (or on account of) income is treated as made for PAYE purposes (ITEPA 2003, s 686(1)). For National Insurance contributions (NICs) purposes, there is also a charge on the earnings of an employed earner, and special rules for directors who are paid annually (SI 2001/1004, reg 8).

HMRC acknowledges (following *Garforth v Newsmith Stainless Ltd*, Ch D 1978, 52 TC 522) that crediting an account in the employer's books represents 'payment' for these purposes. However, HMRC's guidance (in the Employment Income manual, at EIM42320) lists the following examples of entries in accounts or records that are not yet earnings and therefore are not 'caught' for tax purposes: (i) Draft entries in accounts and records (e.g. subject to formal agreement); (ii) Contingent earnings (i.e. which are subject to a condition being met in the future); and (iii) Provisions for future earnings that may be payable in the future but have not yet been agreed.

Dividends

The overdrawn loan account of a director shareholder may be cleared or reduced by crediting a dividend from the company to the loan account. However, care is needed to ensure that the company law requirements are satisfied.

For example, the dividend should be properly voted, paid and formally documented by minutes, dividend vouchers, etc. It is also important to appreciate when a dividend is treated as paid. For tax purposes, dividends are treated as paid on the date when they become due and payable, subject to any provision to the contrary (CTA 2010, s 1168). HMRC's Company Taxation manual includes guidance on company law aspects of dividends (see CTM20095):

'Companies' Articles often provide that:

- final dividends may be declared by the company in general meeting, and
- interim dividends may be paid by directors from time to time.

The significance of this in present context is that a final dividend which has been properly declared and which does not specify a date for payment creates an immediately enforceable debt. If a final dividend is declared under the terms of a resolution that states that it is payable on a future date...then the debt is enforceable, and the dividend is due and payable, only on that later date. An interim dividend, on the other hand, may be varied or rescinded at any time before payment and may therefore only be regarded as due and payable when it is actually paid.' HMRC cites *Potel v CIR (1971) 46 TC 958* as authority for its guidance on interim dividends.

Interim dividends should be handled with caution if they are to be credited to the DLA. HMRC warns (at CTM15205): 'payment is only made when the money is placed unreservedly at the disposal of the directors and shareholders as part of their current accounts with the company. Payment is not made until such a right to draw on the dividend exists, expected to be when the appropriate entries are made in the company's books.' The guidance adds: 'If such entries are not made until the annual audit, not uncommon in a small company, and this takes place after the end of the accounting period in which the directors resolved that an interim dividend be paid, then the due and payable date is in the later rather than the earlier accounting period.'

DLA repayments

Aside from the crediting of earnings or dividends, the director may simply repay an overdrawn director's loan account with a monetary amount by cheque, bank transfer etc. from the director's private account.

A risk area identified in HMRC's 'Director's Loan Account Toolkit' is: "If the date of repayment is not properly identified relief could be claimed in the wrong accounting period and the Company Tax Return may be incorrectly completed."

It is possible that numerous DLA repayments will be made over a period. There is no tax legislation explicitly covering the allocation of payments for these purposes. However, in *AJM Mansell Ltd v HMRC [2012] UKFTT 602 (TC)*, the FTT noted the following general principles (derived from 19th century common law cases):

- Separate debts: Where a debtor makes a payment to a creditor he may appropriate the money as he pleases. However, if the debtor does not make any appropriation, the right of appropriation devolves on the creditor (*The Mecca [1897] AC 286*).
- Running accounts: Where the debtor has a 'running account' with the creditor (e.g. a bank account), a payment is allocated to the earliest debt (*Clayton's case [1816] 1 Mer 572*).

The *AJM Mansell Ltd* case concerned monthly PAYE and NICs. The tribunal found that each month's liability was a separate debt, so there was no 'running account'. This meant that the rule in *The Mecca* applied, so the employer could allocate its PAYE and NICs payments in any way it chose, provided it did so before the money changed hands.

HMRC's guidance states (at CTM61600): "Where there are a number of loans/advances on a single account, any parties involved (participator and/or company) can specify against which debt they want to set the repayment. Where they do not specify, you should set the repayment against the earliest debt first following the rule in *Clayton's Case*..."

Rewriting the DLA

HMRC's DLA toolkit indicates that there is a possible risk if transactions relevant to DLAs have not been posted contemporaneously. It adds: "Where a contemporaneous record has not been kept, consider whether the loan account should be redrawn to identify if it has been overdrawn at any point during the year."

Furthermore, in the context of an HMRC enquiry, if company funds have been misappropriated by the directors of a close company, the funds should be regarded as loans or advances to those directors, giving rise to a liability under CTA 2010, s 455. This is likely to involve the DLA being rewritten (see HMRC's Enquiry manual at EM8620).

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