Loans to employees and directors

This guide looks at the rules regarding loans made to employees or directors by a company.

As an employer, you may often be willing to lend company money to a director or employee. This could be to help them pay for a season ticket to commute to work, to help an employee relocate to a new area, or to help a valued employee get over a financial difficulty.

There are, however, some rules that must be followed. For example, if the loan is to be repaid in instalments from salary, the employee must either sign an authorisation for such deductions before the loan is made or have an equivalent provision in their employment contract.

Beneficial loans

A beneficial loan is one where the employer lends money either interest-free or at a lower rate of interest than HMRC considers commercially available. This loan can therefore be treated as a benefit in kind (BIK) on which the employee must pay income tax.

There are, however, a number of exceptions where a loan can be made without incurring a tax liability.

Loans below £10,000 a year are not regarded as a taxable benefit, so only loans in excess of this will potentially suffer a charge to tax. This limit applies to the total of loans made to the employee and applies throughout the tax year.

A loan may not be taxable where it arises from a relationship other than one strictly of employment. For example, if you employ your daughter in your personal business and lend her money to buy a new car, it is probable that this would be regarded as a domestic loan made because of your family relationship and not because of the employment relationship.

A loan may be considered a 'qualifying loan' where the loan in question would have fully qualified for tax relief if the employee had actually paid the interest. In these circumstances, the loan would also not be treated as a beneficial loan.

Particular care should be exercised when providing any form of financial assistance to an employee because:

- The legislation is wide enough in scope to include more than simple money lending. For example, it includes guaranteeing a loan, facilitating a loan or even taking over a loan from another person. It also includes loans made to relatives of the employee.
- In addition to the provisions for beneficial loans, some financial arrangements - including informal ones - with employees could come within the scope of the rules on 'disguised remuneration'.

- Anti-avoidance provisions can also apply, for example where there is no intention for the 'loan' ever to be repaid by the employee.

Calculating the taxable benefit

If a loan is a taxable BIK, the tax is calculated using either the **averaging method** or the **alternative method**. These methods can give different figures for the taxable benefit, particularly if the amount of the loan varies during the year. The employer generally uses the averaging method unless they either elect or HMRC requires them to use the alternative method.

If a single loan is made to more than one person, such as to a married couple who both work for the same employer, the tax charge is apportioned between them.

Short-term loans and advances

The normal procedure for a short-term loan is that an advance is made with no income tax or class 1 national insurance deducted at source. On the next pay day, the full amount of gross salary is then taxed and subject to national insurance with the amount of the advance subsequently being deducted from net pay. There is usually no tax liability for the small cash flow benefit the employee has enjoyed.

You must get the employee to acknowledge the amount of the advance and provide authorisation for it to be reclaimed from their pay.

You may be prepared to provide an employee with funds for a business trip. Provided the employee promptly accounts for the funds advanced and repays any unused amount, this will not normally incur a tax liability.

If advances on salary become routine, HMRC may say that an employee is being paid on a different basis, such as being paid twice-monthly rather than monthly.

Loan written off

If you agree to write off the loan, the amount written off may be taxed as earnings. This means that the amount is added to the employee's gross pay for the period when the loan is written off.

There are some exceptions to this, such as when a loan is written off as part of a settlement for a compensation claim. In such a case, the write-off may not incur a tax liability.

However, there are some circumstances where the tax provisions differ, such as for loans written off to participators in a close company. Loans to participators in general cause additional complexities, such as a potential tax charge - payable by the company - of 25% of the outstanding loan balance (not written off) at the end of the financial year.

A liability to tax that arises when a loan is written off continues after the employment has ended but ceases on the death of the employee.

Directors' loan accounts

There are often circumstances where directors lend money to their companies, particularly start-up companies and those which they helped form.

Loans made to directors from these accounts incur no tax liability as the company is only giving back the director some of his or her own money. Similar provisions apply when an employer pays a director’s personal bill from the director’s loan account. However, care must be taken to ensure that withdrawals are not seen to be earnings or payments on account of earnings as HMRC could then argue that PAYE should be applied to the loans made.

Despite this, the situation is completely different if the director’s loan account becomes overdrawn. For example, if the account has £10,000 and a director draws £25,000, the account becomes overdrawn by £15,000. This overdrawn amount could then be regarded as a beneficial loan made to the director and can have tax consequences as a result.

We can advise on the position if you believe a director’s loan account may become overdrawn.

'Commercially available' rates

An interest rate is regarded as not being available commercially if it is below the ‘official rate’ announced by HMRC. This rate is currently 3.25% for periods from 6 April 2014. If an employer charges interest on a loan to the employee at the official rate or a higher rate, it is not taxable as a beneficial loan.

Whilst the interest does not need to be paid in the year of assessment, it must have been actually paid and for the specific year of assessment.

There are also circumstances where an employer may be a bank or other organisation whose business includes lending money to individuals. If such an employer lends money to an employee on the same terms as it would for a member of the public, the loan is regarded as a commercial loan and so would not be taxed as a beneficial loan.

Specialist advice

The rules around making loans to employees and directors can be complex. Contact us now to discuss your plans and concerns.