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Contractor Newsletter Feb 2010 - Directors loans & pension tax savings

In this first update of 2010, we look at the tax dangers of overdrawn director's accounts. In the current economic climate some contractors have drawn on the company's tax reserves for their income - something which now has punitive costs.

We have also mentioned below the tax effectiveness of making pension contributions from your company, as with the fiscal year end approaching many clients are addressing methods of extracting additional amounts from their pre-tax company profits.

Director's Account

It has for many years been the belief that directors can borrow tax free up to £5k from their company (as opposed to taking the money as taxed salary or dividends). However a change in the Companies Act of 2006, which has only recently come into force, has changed the tax dynamics on this borrowing.

The headline for this is that there is now:

- A 25% tax charge on year end directors overdrawn/loan amounts
- Approx 5% interest payable by the director on the amount of the loan
- Significant additional admin costs for reporting the loan and interest computations to HMRC

The burdens of having overdrawn on what is due to a director are thus significant and probably should be avoided at all costs. HMRC have added the 25% tax charge as in the past directors have simply liquidated their companies and not paid the taxes due. This charge is more than paying the corporate tax and is meant to remove any attractiveness of borrowing against money set aside for HMRC.

A director's account is the HMRC term for recording the net money due to a director (in salary, expenses and dividends) against what has actually been taken. If a director had £1k of salary and £2k of dividends, and had drawn all £3k, then there would be a zero balance and no area of concern. The problem arises when the director takes more than £3k and this is magnified when the directors drawings eat into funds set aside for company tax and VAT.

Pension Contributions by your company - save the advisor fees

As the fiscal year comes towards an end, clients of ours are often looking for last minute tricks on saving taxes. For those clients interested in making pension contributions there are tax savings if it is made through the company that would cover the cost of IFA/Advisor fees.

For lower rate tax payers, the saving of making the pension contribution through your company is 1% and for higher rate tax payers it is 3.5%. Smaller advantages are that the administration is straightforward for company contributions and that there is no limit on the amount the company can pay to you (as long as it does not exceed profits).

If you are interested in this, you should discuss it with a financial advisor. Nasa Consulting have a recommended panel of advisors that we would be happy to provide you with contact details for, so please contact your client manager directly.