

The Director Loan Account Dilemma: Asset or Liability

When times are good Director Loan Accounts ('DLAs') accrue until such time as dividends clear them off. Using assets (cash/loans) wisely and tax efficiently is the main driver – happy days.

However when times are tough but loan accounts have still accrued and can't be cleared by way of dividends the directors are at risk of a sizeable personal liability along with the company for extra tax.

To explain this in more detail, business owners often extract remuneration from a company in several ways, but commonly adopt a blend of a nominal salary payment with regular payments (loans) taken throughout the year via later declared dividends. While this approach can be tax-efficient, it carries financial risks to both the company and the director personally if not properly managed, especially in an insolvency scenario.

Dividends – what makes them valid?

Under the Companies Act 2006, dividends must meet specific legal requirements to be valid.

1. Sufficient distributable reserves – dividends can only be paid out of distributable reserves. Reliance must be placed on relevant accounts (e.g. statutory or management accounts). The supporting accounts must demonstrate that retained profits were available at the time.
2. Board Approval - dividends must be formally approved by the board of directors either by way of minuted meetings or written resolution.
3. Dividend Vouchers – a dividend voucher must be issued to the shareholder.

Improperly declared dividends may potentially be challenged as unlawful distributions and subsequently repayable in full should the legal requirements not be met. We commonly see directors within small businesses fail to correctly record the dividend payments, which puts them at personal financial risk at a later date.

What don't directors seem to appreciate?

When the company has insufficient reserves, all transactions between a director and their company that are not classified as salary or legitimate business expense repayments are treated as money borrowed from the company by the director (overdrawn loan).

It often comes as a shock to directors that an overdrawn Director Loan Account is treated as a company asset, therefore would be repayable to the company when a company is wound up. We've heard it all from directors from "..... that's my income....", "...this is what my accountant advised me to do....." or "...no way, the business owes me money....."

Furthermore, directors also seemingly don't appreciate that overdrawn DLAs can trigger significant tax consequences for the company if the loan remains outstanding for 9 months and 1 day after the company's year-end. When a company is possibly already experiencing cash flow challenges, the news that there is a 35.75% tax charge (applicable rate from 6th April 2026) on the loan that they need to factor into any dealings with HMRC is less than ideal.

However, at BRI we appreciate this news can come as a surprise and therefore we will openly explore all the options available to the director and explain the potential personal ramifications in a sympathetic manner.

What happens to the DLA when a company enters insolvency?

The problem doesn't immediately go away, as the appointed Insolvency Practitioner has a duty to investigate the DLA balance and seek repayment from the director. If the director is not in a financial position to immediately repay the loan, the director does have options that can be explored to achieve an acceptable outcome for all parties. Repayment can be achieved through negotiating a payment plan or a settlement agreement in full or in part depending on the individual's personal financial position.

If, however, the director opts not to tackle the problem, this can result in formal legal proceedings, if necessary, which could result in bankruptcy. It is extremely rare for directors to experience this outcome, due to the manner in which we communicate with directors at the very outset. In some cases, conduct around DLAs may also form part of a broader director conduct investigation and potentially invalidate any redundancy entitlement due from the company. Therefore, we cannot stress enough the importance of directors having an appreciation of the risks they face if they commonly find themselves in an overdrawn DLA position.

HMRC current stance: Personal tax exposure?

If the DLA is written off, which commonly occurs in an insolvency where full recovery is not possible, HMRC will typically tax the written-off balance as a dividend, meaning the director could be required to pay tax at the relevant tax rates. This can result in a personal tax liability with no cash received, compounding financial difficulty. In an insolvency context, this tax exposure can arise alongside repayment demands from an insolvency practitioner, significantly increasing overall financial risk.

Furthermore, where the loan exceeds £10,000 and either no interest or below market interest is charged, a benefit in kind may arise and the director could be taxed on the deemed interest benefit.

Guidance and Mitigation

Early advice is critical. Where a business is experiencing financial pressure, directors should:

- Engage their accountant or adviser early.
- Review the reserves position and the dividend policy/paperwork.
- It is best practice to declare dividends regularly (e.g. quarterly/monthly) if profits and reserves allow.
- Maintain up-to-date management accounts.
- Avoid allowing DLAs to become significantly overdrawn.
- Consider adjusting the remuneration structure if profits are uncertain and cash flow is tightening.

Where there are concerns about the company's solvency and an overdrawn DLA exists, it is essential that the client is referred to BRI at an early stage. This enables us to assess the position, advise on the potential implications and support the client in making informed decisions while taking acceptable steps to minimise their exposure.

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