Contractor Doctor: Can I use my limited company money to offset my mortgage?

Dear Contractor Doctor,

As an IT contractor and a sole director and shareholder of my own contractor limited company with no dependants and modest living expenses, I often find myself building up a significant amount of cash during the financial year. Add to that saved VAT money and what I set aside for tax, and it's a huge chunk of cash sitting earning virtually nothing in a business deposit account.

I want to make this cash work harder for me during the year and I've been reading about business offset mortgages that let you use the spare cash built up over time from your business to save on mortgage interest payments. According to bank websites, the money for the business stays in the business account but offsets the balance in the personal mortgage account.

Can I use surplus cash on deposit from my contractor limited company to offset my personal mortgage?

Thanks

Roderick

Contractor Doctor says:

According to James Abbott of contractor accountant Abbott Moore LLP, several problems arise when a contractor tries to make use of limited company funds in an offset arrangement against personal debt. And these problems could result in a hefty tax bill from HMRC or even, in extreme cases, prosecution under the provisions of the Companies Act.

"The first question is whether the contractor's limited company allowing its money to be used by the contractor director to offset personal debts is a beneficial loan for tax purposes," explains Abbott.

"If the use of this facility was termed by HMRC as a beneficial loan and the sum loaned was above £5,000, this would result in the director incurring income tax, at rates of 20%, 40% or 50% on the notional rate of interest (currently 4.0% at the time of writing) of the loan. In addition, the company would pay Class 1A National Insurance Contributions (currently 12.8% at the time of writing) also based on the notional interest rate."

Beneficial loan rules are broad

As Abbott explains, although bank literature might say that the business's money technically remains in the business account, the shareholder is deriving the benefit from the money, and the legislation is broad, saying transactions that are "arranging, guaranteeing or in any way facilitating a loan" would be considered beneficial.

"If the bank has the right to offset the personal loan against the company's money, HMRC would argue strongly that it would be caught under the beneficial loan rules," warns Abbott.

"Alternatively," he continues, "HMRC may argue that the interest forgone by the company should be charged as a benefit in kind [BIK] on the director, as this would be a cost to the company of providing the benefit. Both are real risks."

In another scenario, Abbott suggests that HMRC might argue that the money was effectively a directors' loan. In this case S419 tax would apply, landing the contractor's limited company with an equally nasty tax bill.

Directors must act in the best interests of the company

"In addition to the tax implications of using company money to offset personal debts, contractors may also be flouting new rules introduced by the Companies Act 2006," explains Abbott. "These rules are quite explicit about directors' responsibilities, in particular where there is a conflict of interest or benefit derived by the director."

New duties from 1 October 2007 include a requirement to promote the success of the company, and from 1 October 2008 not to accept benefits from third parties, plus a duty to declare an interest in a transaction. In extreme cases, breaking these rules can lead to prosecution in the courts.

"For the vast majority of contractor limited companies with one or two directors and shareholders, the new provisions for directors are unlikely to be enforced, as an action can only be brought against a contractor by the company itself, or a liquidator when the company is in liquidation."

Sole traders and partnerships can use offset mortgages

Banking products that allow proprietors of businesses to use their business balances to offset personal debts, such as mortgages, are primarily designed for sole traders and partnerships, where the individuals are the company and there may not even be a separate account for the business.

“I would never recommend any kind of offset mortgage product where the contractor wants to use funds still held in a limited company bank account as part of the offset arrangement,” concludes Abbott. “However, contractors can still use funds held in personal banks accounts to offset a personal mortgage.

> **“In addition to the tax implications of using company money to offset personal debts, contractors may also be flouting new rules introduced by the Companies Act 2006”**
>
> James Abbott, Abbott Moore LLP

James Abbott

Owner

Abbott Moore LLP

James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. Read Full Profile...

View all our experts

“For sole traders and partnerships where the business bank accounts are in the names of the partners, they can potentially save the proprietors considerable sums in mortgage interest.”

Good luck with your contracting!

Contractor Doctor

Published: Friday, June 11, 2010