

The Taxation Of Directors' Loan / Current Accounts

The Story So Far...

1. 1990 : IRAS review. Employees will not be taxed on the imputed benefits of interest-free loans or loans at below market interest rates, provided by employers, so long as the employees do not : (1) have substantial shareholdings; or (2) do not have control or influence over the company.
2. 1993 : S.2(a) of the Income Tax Act amended to deem "a director" an employee.
3. 1998 : IRAS has specifically listed interest-free/subsidised loans to employees as taxable benefits in its Form IR8A.
4. 1999 : *NYK & Anor vs Comptroller of Income Tax* - Case started

NYK & Anor vs Comptroller of Income Tax (Income Tax Board of Review, Appeals No. 4 to 11 of 1999, MSTC 5297). Judgment delivered 23 March 2001.

The two taxpayers were directors and shareholders of NHA & Sons Pte Ltd, a family investment holding company. They did not enter into any contract of service with the Company and did not receive any wages or other remuneration. The loans outstanding for 1993 to 1996 ranged from S\$2.997 million to S\$7.758 million. There were four issues before the court :

1. Were the taxpayers employees despite not having contracts of service and not drawing any salary or remuneration?

Yes, - "*by operation of law*" through section 2(a) of the Income Tax Act (1993 amendment) which states "*employee – in relation to a company, includes a director of the company*". The Board agreed with the Comptroller that the 1993 amendment was intended to close a tax loophole - directors could choose not to enter into any contract of employment and give themselves perquisites rather than cash.

2. Were the interest-free loans given to the taxpayers “in respect of” gains or profits from an employment?

Yes - the interest-free loans were perquisites of employment in that there was a personal advantage from the loans i.e. the interest saved

3. Were the interest-free loans “advances on capital” to shareholders?

No – There were repayments to these loans. Advances on capital need not be repaid or returned but loans would have to be. Advances on capital will mean a reduction of the share capital and requires compliance with the Companies Act. (Company had undistributed capital reserves of between S\$17 million to S\$22 million). Note :

taxpayers did not argue that these were distributions or dividends in which case section 44 may be an issue

4. Was the interest rate used by the Comptroller reasonable?

Yes – the Comptroller had used the lowest prime lending rate which a bank would extend to its most credit worthy customers.

Note : The Board of Review concluded “Without this (1993) amendment the appellants would not have been chargeable to tax on the interest benefit ”

NYK & Anor vs Comptroller of Income Tax

Taxpayers appealed the March 2001 Income Tax Board of Review’s decision to the High Court. The High Court reaffirmed the Board’s judgment in July 2001. Following the High Court judgment, IRAS launched an audit programme in Sept 2001.

IRAS has extended the deadline for voluntary disclosures to 30 Nov 2002. Taxpayers will pay the back taxes and a penalty of 5% p.a. on the back taxes. Under the Income Tax Act, the penalties are : (a) 100% for incorrect returns (b) 200% for negligent returns and (c) 300% for fraud; in addition to the back taxes.

Basis Of Taxation

Where interest-free or interest-subsidised loans are made to the directors of a company, the directors derive a benefit from such loans. The income tax law regards company directors as employees, and the benefits so derived from interest-free/subsidised loans are taxable as employment benefits.

IRAS accepts that interest free/subsidised loans made to directors in their capacity as shareholders are not perquisites of an employment.

There must be evidence to show that the loans are given solely in their capacity as shareholders for bona-fide reasons other than tax. This will be the primary factor IRAS will look for in determining the true nature of loans.

IRAS’ Guidelines On Determining Shareholder’s Loan - the latest position

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The Four Elements

1. There are bona-fide (other than tax) reasons for the company to extend loans to directors/shareholders in their capacity as shareholders, instead of paying them dividends or returning excess capital to them.
2. The loans are not remuneration nor benefits to directors disguised in the form of loans to shareholders. They are not intended to be dividends or a return of capital.

3. Evidence of a genuine creditor/debtor relationship between the company and shareholders. Evidence to support that it has reasonable expectation of the loans being repaid.
4. The terms of the loans should generally be those found in a typical loan arrangement e.g. there is a repayment schedule or repayment terms are provided etc.
5. The loans are extended to ALL shareholders rather than only to directors/shareholders.
6. The loan quantum should be determined on the basis of their respective shareholdings or other equivalent basis and not due to influence or position held by any director/shareholder in the company.
7. Similar loan terms (e.g. repayment schedules, interest rate charged, if any etc) should be applicable to ALL shareholders.
8. Contemporaneous documentary evidence in the form of directors' or board's resolutions, approval at shareholders' meeting, minutes of meetings or other records etc, are available to support that loans are made to the loan recipients in their capacity as shareholders (and not as directors) of the company.

The Future For Directors' Loans

1. No Tax Liability on Shareholders' Loans if you are NOT a director. Note the Comptroller has powers to tax undistributed profits as distributed dividends under section 30 (if there is a tax motive).
2. A Director is deemed to be an Employee under the Income Tax Act, you need to keep track of all benefits in cash and money's worth as these will be taxable.
3. You are on stronger grounds if a director can demonstrate that his loan is granted under the same terms and conditions as are for all loans to all employees, for example under an Employee Loan Scheme for Housing, or under an Employee Loan Scheme for Private Cars.
4. What is important is that the director should not have the benefit of interest-free or interest-subsidised loans *due to his influence through shareholdings, or his position as a director*.
5. You must be able to demonstrate that the interest-free or interest-subsidised loans are not made for tax reasons, for tax motives, for personal benefit or personal advantage.
6. Partners and sole proprietors can freely draw money in and out of the business without any tax liability as they are not employees and the money belongs to them. Not so for companies.
7. It is necessary to keep track of the movements on the loan accounts and identify the reasons for each payment (and repayment) made by the company to you or on your behalf. See your accountant!
8. You should document and minute loan arrangements, loan repayment terms, and other conditions of the loans. See your lawyer!

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