MOORE

Restructuring & Insolvency

DON'T GET CAUGHT OUT BY UNLAWFUL DIVIDENDS

Many shareholder directors take part of their remuneration as dividends – but failure to comply with legal requirements could have serious personal consequences.

WHY PAY DIVIDENDS?

It is common practice for shareholders to take a minimum salary, paying the rest of their remuneration as dividends. This approach can reduce tax costs. As of 5 April 2020, the first £2,000 of dividend income will be received tax-free, but any dividends received in excess of £2,000 will be taxable to the extent they are not covered by an individual's personal allowance. However there is still a tax benefit in extracting funds by way of dividends rather than salary or a bonus, taking into account income tax, national insurance contributions and corporation tax paid by the company, although in general the amount of the benefit has reduced.

THE LAW ON DIVIDEND PAYMENTS

The payment of dividends is covered by UK law. The Companies Act 2006 (Part 23) states that:

- a company may only pay a dividend out of accumulated realised profits after accumulated realised losses;
- directors must refer to accounts showing the company's profits, losses, assets and liabilities – such as the latest annual accounts;
- interim accounts may be used instead, as long as they allow a reasonable judgement to be made as to the company's profits, losses, assets and liabilities, provisions and share capital and reserves;
- for a public company, the rules are much stricter.

Note also that directors have a fiduciary duty to:

- act in the best interests of the company;
- exercise reasonable care, skill and diligence;
- promote the success of the company, safeguard its assets and take reasonable steps to ensure that debts can be settled as they fall due.

WHEN ARE DIVIDENDS PAID UNLAWFULLY?

Dividends may be paid unlawfully in a number of circumstances including:

- where profits have been miscalculated or an incorrect figure from the accounts is used;
- where there is poor record keeping – this could include incomplete minutes from a board meeting;
- if the company becomes insolvent.

WHAT IF THE COMPANY BECOMES INSOLVENT?

There are further considerations if the company's solvency is in doubt:

- directors will need to assess whether the company will still be solvent following a proposed distribution;
- if not, the directors could face claims on the basis that they have breached their fiduciary duties or are guilty of misfeasance;
- if the dividends were paid before the insolvency occurred, they could be treated as a 'preference' – such claims can be pursued by a liquidator;
- the directors could face bankruptcy if unable to repay the dividends.

MINIMISING YOUR RISK

Follow some essential ground rules:

- when calculating dividends, if possible, use the last annual accounts circulated to members;
- if you have to refer to interim accounts, make sure these enable a reasonable judgement to be made of the company's financial position: the accounts should show sufficient retained profits available to cover the dividend payment after all appropriate liabilities and provisions have been deducted;
- as the legality of dividends relies on the accuracy of calculations, seek your accountant's advice before paying a dividend;
- draw up proper paperwork every time a dividend is declared, including:
- directors' board minutes approving the dividend;
- interim or annual accounts;
- dividend counterfoils;
- seek advice from an insolvency practitioner if there is uncertainty regarding the company's solvency;
- remember, ignorance of the law is no defence!

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