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Dividends and Loans
- tax and other considerations for the OMB

Avoid pitfalls whilst extracting profits from your company tax efficiently. This briefing considers the tax and other considerations of both dividends and loans for the owner managed business (OMB) trading as a company.

Dividends

Issues to consider here include:

- the tax treatment of dividends
- company law requirements
- how to avoid illegal dividends
- dividend waivers.

Tax treatment of dividends

For quite a few years now, it has generally been more tax efficient for owners of businesses trading as companies to extract profits as dividends rather than salary and bonuses. Decreases in the rate of corporation tax and increases in national insurance contribution (NIC) rates in the last two tax years have reinforced this trend.

A dividend paid by a company is not deductible against corporation tax profits but the absence of NIC and the lower effective rate of income tax on dividends make up for the lack of a corporation tax deduction. Due to the effect of a notional tax credit being applied to a cash dividend, the current effective rates of income tax on a dividend are:

- nil for a basic rate taxpayer (rather than 20%)
- 25% for a higher rate taxpayer (rather than 40%)
- 36.1% for an additional rate taxpayer (rather than 50%).

Company law requirements

One side effect of this is the attention HMRC may pay to the company law requirements of dividends. If HMRC can show that dividends are unlawful from a company law perspective at the time of payment, then they could argue that the money extracted was not a dividend but a loan. The tax effects of a loan to a shareholder are covered later in this briefing. In addition there are non-tax effects that may impact on the directors and the shareholders of a company. These effects are summarised in the company law requirements of this briefing.

One situation where HMRC may take a closer look at a company is where the business suffers a reduction in profits and yet the shareholders continue to extract regular dividends of a similar amount to earlier years.

So what are the company law requirements?

The rules governing the distribution of profits can be complex. These rules have been established predominantly to protect the interests of creditors. Should a company go into liquidation, creditors have the right to repayment in preference to shareholders. This may not be fully possible if shareholders have taken more than they are entitled to as dividends.

As such, strict rules are necessary to govern dividends with consequences for shareholders and directors if the rules are breached.

General rules

A company can only make a distribution by way of a dividend out of profits available for that purpose. These profits are defined as its accumulated realised profits not previously utilised, less its accumulated losses not previously written off.

In order to determine whether a dividend payment may be made, the Companies Act 2006 requires justification of the distribution by reference to relevant accounts.

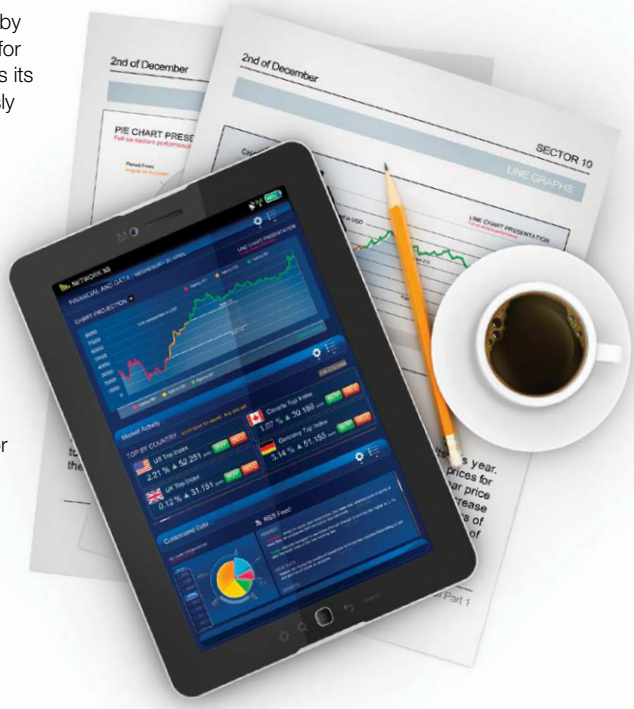
Relevant accounts of a company means:

- the last annual accounts prepared in accordance with the Companies Act or
- the interim accounts (in some cases) where an interim dividend is being considered by the directors or
- the initial accounts if it is a company's first trading period.

Both interim and initial accounts must enable profits, losses, assets, liabilities, share capital and reserves to be determined.

Final or interim dividends?

Interim dividends are those decided upon during the financial period. These are recommended by the directors. The dividend is then approved during a board meeting of the directors and minuted. Before declaring an interim dividend, the directors must satisfy themselves that the financial position of the company warrants the payment of such a dividend out of profits available for distribution. So the last accounts prepared in accordance with the Companies Act would initially be considered. If these do not show sufficient accumulated profits (as earlier dividends have been paid or are payable out of them), interim accounts would be required. The interim accounts are those necessary to enable a reasonable judgement to be made as to the amount of the distributable profits.



The dividend can then be paid to shareholders and the dividend voucher issued.

A final dividend is recommended by directors and approved by shareholders at their general meeting or, as is often the case for private companies, by the members passing a written resolution.

Once this has been undertaken the payment and voucher can be distributed to the shareholders.

Consequences of unlawful dividends

An unlawful dividend is any distribution or part of one, made by a company to its shareholders that breaches the rules on dividend distribution in the Companies Act.

The consequences of a breach in the law render the shareholders liable to repay the dividend to the company if at the time of the distribution they knew or had reasonable grounds to suspect it was unlawful. No such liability exists in respect of a shareholder who is an innocent recipient. This principle relates mainly to the liability of a shareholder in a quoted company, who cannot be expected to have detailed knowledge of the day to day running of the company. For an individual who is both a director and shareholder of a private company it will be difficult to argue innocence.

Should an unlawful dividend be distributed, directors are considered to be 'in default' if they permit or fail to prevent the breach. This can lead to a liability that the directors have to pay personally.

How to avoid illegal dividends

The law is very specific about dividend procedures and even a minor technical breach of them may lead to an unlawful dividend. The most likely breach is where there are insufficient profits to make a distribution and the most likely example of this is where interim dividends are paid.

This is often caused by the failure to prepare relevant accounts before making a dividend payment as the lack of accurate information about the level of available profits can result in an excess distribution.

It should be remembered that there are other methods of withdrawing funds from a company and although dividend distribution is tax efficient, care should be taken when undertaking this method of extraction.

Please contact us if you need further detail on the procedures for making or proposing a dividend.

Dividend waivers

What is the point of a dividend waiver?

When a company pays a dividend and there is only one type (class) of share, all shareholders receive a dividend in proportion to their shareholding. A majority shareholder in a family company may prefer not to receive their dividend so that the available cash to pay a dividend is directed to other family shareholders. This may shield the majority shareholder from higher rates of tax and also help to retain an entitlement to the personal allowance (which reduces once total income exceeds £100,000).

What to watch out for

There are two main areas to consider:

- that correct legal procedures are followed and
- whether tax anti-avoidance provisions apply.

If correct procedures are not followed, HMRC can assess the shareholder to tax on part of the overall dividend. The same effect would apply if tax anti-avoidance provisions apply.

Correct procedures

The waiver of a dividend is only possible before entitlement arises. A waiver properly made involves more formality than a simple request not to pay dividends or to pay them elsewhere. Use a formal deed to effect the waiver. It is not a complicated document and we can advise you on this.

Tax anti-avoidance provisions

Where a dividend waiver is used to divert income to other shareholders, HMRC may challenge the waiver on the basis that it constitutes a settlement for income tax purposes. The practical effect of this is similar to an invalid waiver meaning that the dividend received by the other shareholder(s) may be assessed on the shareholder who has waived the dividend.

Not all waivers are caught. An element of 'bounty' is needed for the settlement provisions to apply. HMRC's view is that 'bounty' is present where a dividend waiver enables one or more of the shareholders to receive a larger dividend than would have been possible had no dividend waiver taken place. This could include a situation where the dividend declared could not be satisfied out of the distributable profits unless a waiver was made by one or more shareholders.

Implications of directors' loans

Loans frequently arise between a company and its director/shareholders. Often, the loans are made from the company to an individual director/shareholder but may also arise when the company itself is in need of additional funds. The tax effects of both types of loans are summarised below.

Loans from the company

The company perspective

A tax charge arises where a loan advance (or an increase in a loan) made to a director/shareholder during the accounting period remains outstanding nine months and one day after the end of the accounting period (the due date). The tax rate is 25% of the amount of the loan which existed at the end of the accounting period and which is still outstanding at the due date.

If the loan is repaid in full (or in part) in a later accounting period, this tax (or part thereof) will then be repaid nine months and one day after the end of that accounting period. For example, if a loan was repaid in January 2012 and the company's accounting period ends on 31 December 2012, the tax relating to that loan would not be due for repayment until 1 October 2013 – nearly two years after the repayment of the loan. If instead the repayment was made on the last day of that same accounting period on 31 December 2012, the tax refund would still be due on 1 October 2013.

What tax implications are there for the director/shareholder?

If loan interest is either not charged or is charged at less than the official HMRC rate (currently 4%), a taxable benefit will arise. This is generally calculated on an average basis, using average capital outstanding during the tax year and the average interest rate prevailing. Where there is significant fluctuation in loan balances and/or HMRC interest rates then an actual basis (amounts and rates) may apply instead.

Whatever the resulting benefit, this is then charged to income tax at 20%, 40% or 50%, depending on the circumstances of the individual. The company as employer (but not the employee) will have to pay 13.8% NIC on the employment benefit.

There is no taxable benefit if interest is charged at the official rate or for certain qualifying loans. There is also an exemption where non qualifying loans do not exceed £5,000 at any time in the tax year.

What happens if the loan is written off by the company?

If a loan is written off, an individual who is both a director and shareholder is assessed on the income as dividend income, as opposed to earned income. The effective tax rates are therefore the same as if an actual dividend had been paid to the shareholder.

Although from a tax viewpoint the income is not assessed as earned income, HMRC generally consider the dividend to be subject to Class 1 employer and employee NIC.

From the company's point of view, the loan write off is essentially a bad debt for accounts purposes and is initially treated as an expense in the profit and loss account. But is it deductible for corporation tax? The short answer is no. To remove the argument that a tax deduction is due, tax law was changed so that there is no corporation tax deduction for shareholder loan write offs made on or after 24 March 2010.

The impact of NIC means that it is preferable to pay a real dividend to enable the loan to be cleared. But, as explained earlier, there needs to be sufficient distributable profits to allow the payment of a dividend.

Company as borrower

If the company is in need of additional funds the director/shareholder may wish to lend money to the company. It will generally be tax efficient to charge interest and thus extract money from the company in this way.

This is because the interest charged, provided it does not exceed a commercial rate, will generally be tax deductible for the company. The company is generally required to withhold 20% tax, which is then paid over to HMRC.

In the hands of the director/shareholder, the income will be taxable as savings income and charged at 20%, 40% or 50%, depending on individual circumstances (with a credit given for 20% tax deducted). No NIC will be due as this only applies to earned income. This will benefit both employer and employee. Please do not hesitate to contact us for further advice or assistance in connection with these matters.

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