Tell me more about when I can't take a dividend

Do you need to be making a profit to extract Dividends?

You can't take dividends out of your company if it has insufficient distributable proft. You can pay yourself a salary, but not dividends because dividends by their nature are a distribution of profit. So, if you take too much e.g. more than the company is making, it's illegal and HMRC will view this as a loan to you and will be taxed on it.

Illegal Dividends

Illegal dividends arise when a company has insufficient distributable profit to cover the sums of money it has chosen to pay to its shareholders.

In accordance with the Companies Act 2006, a company is only permitted to issue dividends or make other distributions to shareholders out of profits that are available for that purpose.

Shareholders receive profits from companies in the form of dividends. The amounts paid depend on how much profit is available for distribution and the percentage and category of shares owned by each shareholder. Issuing dividends is a simple process in small companies.

However, sometimes mistakes are made, and a company declares dividends that are greater than the amount of profits available. When this happens, the dividends are illegal (also known as unlawful dividends or unlawful distributions).

This is not a criminal offence but there may be consequences for the company and any shareholders who receive such unlawful distributions.

In simple terms, Section 830 of the Companies Act says "dividend payments can only be made from realised profits that remain after a company has accounted for all the business losses, costs, expenses and taxes falling due. If there is no money available after taking all of these things into consideration, dividends must not be paid."

Realised profits are profits the company has actually received, in other words income earned from trading or selling assets.

A company could possibly also have unrealised profit such as revaluation of assets.

A company does not need to wait until its annual accounts are published in order to declare a dividend.

Interim management accounts can be used for this purpose, particularly in a company's first period of trade. It is therefore essential to have up to date accurate accounts available whenever a dividend is declared.

Common Mistakes

Some of the common mistakes that result in the payment of illegal dividends are as follows:-

- Failing to ensure the company has sufficient distributable reserves to cover the dividends.
- Issuing dividends without referring to accounts.
- Miscalculating profits or using an incorrect figure in the accounts.
- Issuing dividends when the company is insolvent.
- Failing to follow correct administrative procedures when declaring dividends, in other words not passing a resolution of the board to authorise them.
- Failing to prepare minutes of board meetings or general meetings at which dividends are declared.
- Not completing dividend vouchers which show the share details rate per share and dividend amount.
- Backdating authorisation paperwork for previously issued dividends. HMRC views this as fraudulent.
- Failing to consider the company's future and contingent liabilities when assessing its solvency.

Consequences of using illegal dividends:

If you declare dividends that exceed the company's retained profits, they cannot be cancelled.

Section 847 of the Companies Act states that, if a recipient knows or should have known that a dividend payment is illegal, they are liable to repay the amount of that dividend back to the company.

Claiming lack of awareness or knowledge of the rules is not a reasonable excuse.

Anecdotal evidence suggests that many small companies whose income dried up during the pandemic, took Bounce Back loans and then used that money to pay director/shareholders in the absence of any other available funds. If these companies did not have available reserves, such payments would most probably be illegal dividends.

Payment of a dividend without it having been properly declared is not a dividend and failing to declare a dividend properly means the transaction may well have to be reversed and repaid to the company. This was established by the courts in 2020 and will be particularly relevant if a company has subsequently gone into liquidation.

Some shareholders may be genuinely unaware of the company's financial position or, if there is a large shareholder base, it may not be practical to recover illegal dividends. In that case, the liability passes to the director who sanctioned payment who therefore may not only have to pay their own unlawful dividends but those distributed to other shareholders.