Paying dividends – are they properly declared

For many personal and family companies, the most tax-efficient way to extract profits is to pay a small salary and to take anything in excess of this as a dividend. However, in order to benefit from the more favourable tax rates and lack of National Insurance attached to dividends, the dividend must be properly declared.

What does this mean?

Sufficient retained profits

The first point to note is that dividends are paid from retained profits. These are profits after tax which have not already been distributed. Dividends come out of retained profits and the retained profits must be sufficient to cover the full amount of the dividend.

If a dividend is paid when the company lacks sufficient retained profits to pay that dividend, it is an unlawful distribution and must be repaid.

Paid in proportion to shareholdings

Dividends must be paid in relation to shareholdings. So, if there are one hundred shares and a dividend of £5 per share is paid, a shareholder with 20 shares must receive £100 (20 x £5), a shareholder with 40 shares must receive £200 (40 x £5), and so on. It is not possible to tailor the payment to the shareholders so they receive a different amount per share. If it is desirable to pay dividends at different rates to different shareholders, an alphabet share structure should be employed.

Interim dividends

The directors can declare an interim dividend. They must, however, consider the financial health of the company and ensure that the company has sufficient retained profits from which to pay the dividend. The decision to pay a dividend should be minuted.

Final dividend

A final dividend is recommended by the directors but must be approved by the shareholders in general meeting or by written resolution. They are normally paid at the end of the year. The resolution should be signed by the shareholders.

Dividend vouchers

A dividend voucher should be given to shareholders each time a dividend is paid. This is effectively a receipt. The dividend voucher should show the name and registered address of the company, the name and address of the shareholder, the description of the shares, such as ordinary shares, the number of shares owned at the time the dividend was declared, the amount of the dividend paid, and the date. The voucher should be signed.

Getting it wrong

The cost of getting it wrong can be high. Unless a dividend is properly declared, it is not a dividend and HMRC may seek to tax it as a salary payment instead – with the associated National Insurance and higher rates of tax. At best, it would be regarded as a loan to the director/shareholder, which would have to be repaid and may trigger a section 455 charge and a benefit in kind charge on the loan.