Illegal dividends explained – what are they?

Contractors failing to justify **dividend declaration** decisions and not completing the correct **dividend paperwork** for their **contractor limited companies** could have their dividends declared illegal by HMRC. Contractors found to have paid illegal dividends could be forced to pay income tax and National Insurance Contributions (NICs) on income then reclassified as salary. And, if not repaid, an illegal dividend could be classified as a directors' loan, potentially attracting S455 (formerly S419) corporation tax and a charge for benefit in kind (BIK) on the interest.

"An illegal dividend can be declared when there are insufficient profits to cover the dividend at the time of payment," explains **James Abbott**, owner and head of tax at contractor accountant **Abbott Moore**. "A dividend can also be illegal if a contractor fails to complete **board meeting minutes of the dividend decision** and a dividend voucher for shareholders, according to the requirements of the **Companies Act**."

Abbott warns contractors that HMRC has in recent years focused on the legality of dividends: "A contractor's accountant will put any illegal dividends into the **director's loan account** before the accounts are submitted to HMRC. If the contractor is then the subject of an HMRC enquiry, HMRC may and try and argue that the illegal dividend should have been treated as salary at the time of the payment.

"If HMRC do find that the dividend was not legal the result might be a bill for additional income tax, NICs, penalties and interest, particularly if the loan is later cleared by salary."

What is an illegal dividend?

According to Abbott, contractors will find HMRC uses the term ultra vires dividends to describe dividends it considers illegal, with ultra vires literally meaning 'beyond the powers'. In plain English, it means that company directors declaring a dividend when there are insufficient profits don't actually have the authority to make that decision – i.e it is illegal for them to pay themselves that dividend as per tax laws.

"In addition to the requirements of the Companies Act, and for there to be a profit at the time a dividend is declared, there is a common law principle that if directors should not declare a dividend when it would not be prudent to do so, this would also be considered to be an illegal dividend."

Abbott says that most one-person mainstream contracting businesses would be unlikely to fall foul of common law dividend rules, but contractors who diversify their business into other areas – such as software, employment businesses, investments or property – should be aware that directors need to act in the interests of the company and protect company assets. In this situation if paying a dividend could jeopardise the assets of overall health of the business then it could be declared illegal.

"Contractors who have diversified also need to be aware that company law says certain types of profit cannot be legally distributed as a dividend," adds Abbott. "Determining payouts in these instances should involve the contractor's accountant to avoid them being declared illegal dividends."

Calculating profits to avoid illegal dividends

A dividend can only be declared from company profits. To avoid the risk of paying illegal dividends contractors need to keep basic management accounts and to perform a simple calculation each time they declare a dividend.

As Abbott explains, most contractor accountants will offer contractors two options: "The contractor will be required to input all their transactions into an online system or spreadsheet, which will provide a detailed breakdown of their financial situation, including profits. However, the information added by the contractor must be very accurate to ensure the calculations are correct and illegal dividends aren't paid as a result of incorrect financial information.

"The alternative is to use a simple calculation – subtracting expenses including any salary, from fee-income revenues, taking off a further 20% to allow for corporation tax. The figure left is profit," says Abbott. "Technically what's left can be legally paid as a dividend, but ideally contractors should not take the full profits so there is spare cash for any adjustments that are made at year end."

Abbott stresses the importance of keeping a record of any calculations, which could be as simple as saving a basic paper spreadsheet, so that the contractor can prove that at the time the dividend was declared the company was in profit and dividend payments were legal.

How to correct an illegal dividend

Contractors could be liable to repay an illegal dividend if they knew, or should have known, that the dividend was illegal when it was declared. As in the majority of contractor limited companies the shareholder is also the director, it would be difficult to prove that the contractor did not know the dividend was illegal.

Abbott has further advice: “Don’t backdate documents, such as board minutes, dividend vouchers and calculations, as that makes them legally void and is a criminal act. And if as a contractor you have never kept these kinds of records, you should start immediately otherwise you will have no way to prove the legality of dividends in case of a HMRC investigation. However, if you’ve kept the records that prove the decision to declare a dividend subsequently deemed illegal was a reasonable judgement at the time, then HMRC would have difficulty in classifying this income as salary.”

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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

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Abbott concludes: “It would be unusual for a contractor with a straightforward contract paying ongoing fee income to declare an illegal dividend as long as the contractor takes simple measures, such as calculating profits and keeping clear records of each payment.”

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