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ILLEGAL DIVIDENDS AND THE PANDEMIC

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About this guide

This mini guide is a compilation of a series of three articles that were published in our Tax Insider Professional newsletter. Each of the articles covers a different aspect on 'illegal' dividends, that is, if a company pays dividends it cannot afford.

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About Lee Sharpe

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'Illegal' dividends and the pandemic (Part 1)

Lee Sharpe takes a tax-centric look at what happens if a company pays dividends it cannot afford.

This article will look at 'illegal dividends' (perhaps more clinically, 'unlawful distributions') and the tax implications that flow therefrom. The focus is on owner-managed businesses and family companies – normally 'close' companies within CTA 2010, Pt 10 (s 438 et seq.).

It is important to note that HMRC in general is by no means the arbiter or authority on what constitutes an illegal dividend. It is a matter of company law, and more the preserve of lawyers and insolvency experts. Having said that, a company should (in theory at least) never pay an illegal dividend and, by implication, it is something with which all directors should be familiar.

Why are illegal dividends relevant?

The two main reasons why unlawful distributions are at risk of becoming more commonplace (or at least more commonly identified) will be down to the acute financial shock attributable to Covid-19 and changing consumption patterns as a result. We do not yet know what the long-term trends will be, but: there will be large losses, and there will be insolvencies.

Where an insolvency practitioner is appointed to deal with a company in distress, its recent dividend history will often be scrutinised to see if there are any irregularities that may have put creditors' interests at risk.

To determine if a distribution has been made unlawfully, the first place to start is Companies Act 2006, which sets out how distributions might be made lawfully.

What makes a 'legal' dividend?

A distribution can be made only out of profits available for the purpose, the basic definition being its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made (CA 2006, s 830). There are further restrictions imposed on public and investment companies.

To determine the quantum of distributable profits available at the point of making a dividend, one must refer to the 'relevant accounts', being:

- The last statutory accounts or, where they indicate that accumulate profits are insufficient
- Suitable interim accounts may be prepared (there are similar provisions to cover where a company is too 'young' to have prepared statutory annual accounts, etc.) (CA 2006, ss 836–840).

These are the basic provisions. However, the Companies Act also states that regard must be had both to common law and the company's own Articles of Association, to include the so-called 'capital maintenance rule', which requires a director to ensure that a dividend will not erode the company's capital at the point of proposal and, if later, on payment. Where a dividend has not been made in line with the foregoing, it will be unlawful.

Consequences of an 'illegal' distribution

Where a shareholder knows or has reasonable grounds for believing that the distribution (or part of it) has been made unlawfully, the shareholder is liable to repay it (or the 'unlawful part'). This extends to having to pay an amount of cash equivalent to a distribution made in specie. (CA 2006, s 847).

Furthermore, a director can be held personally liable for any breach of his or her fiduciary duty to the company and can be required to restore the funds to the company (IA 1986, s 212 et seq.).

These are the reasons why insolvency practitioners will review a company's dividend history (amongst other things) to determine if a claim should be made against shareholders and/or directors. Such claims would not be limited only to unlawful distributions, but that is what this article and HMRC will focus on. In particular, HMRC's course of action will be decided independently of any claims by an insolvency practitioner.

Tax treatment of 'illegal' dividends

HMRC treats a dividend it perceives to be illegal as being repayable to the company, in line with company law. While case law treats the liability to repay as the shareholder's holding the funds 'on constructive trust for the company', HMRC considers this equivalent to a loan and, for a 'close' company, a loan to a participator (within CTA 2010, s 455).

As noted above, company law requires repayment only where the shareholder knows, or should have known, that the dividend exceeded available distributable reserves at the time it was made. However, HMRC argues that 'when dealing with private companies controlled by directors who are shareholders, such a [shareholder] ought to know the status of the dividend and it is expected that section CA 2006, s 847 will apply in the majority of such cases' (see HMRC's Company Taxation manual at CTM15205).

Note that the legislation applies where the company makes a loan or advances money to a participator (shareholder) in the company. When it comes to illegal dividends, HMRC will look at such 'loans' separately, ignoring any credit balance the company might otherwise owe to the shareholder (see CTM61565). But this might be a difficult line to take where dividends are traditionally credited to the director/shareholder's loan account and it would remain in credit regardless of any 'illegal' distribution.

Practical considerations of an illegal dividend

Assuming HMRC's treatment is correct, a company will be obliged to file a supplementary form CT600A with its usual tax return. The statutory accounts submitted alongside should also include relevant disclosures.

The section 455 tax will have been payable alongside the main corporation tax liability – assuming there was one – at nine months and one day after the end of the chargeable period in which the distribution was made. The company may seek relief under CTA 2010, s 458 for any amounts repaid prior to that date, but HMRC may not accept that general directors' loan repayments were made specifically against that debt to the company, and in any event this may simply 'move' the section 455 liability to a different debt.

HMRC may also argue that the repayable amount is by implication also an interest-free loan made to an employee of the company, resulting in a taxable benefit-in-kind (or increasing one that already arose).

On a more positive note, HMRC does say that a distribution paid unlawfully is not a dividend:

'The company has not made a distribution as a matter of company law, and so the dividend does not form part of the recipient's income for tax purposes' (see CTM15205)

So the director/shareholder's personal tax liability should fall.

Implications if HMRC spots it first

If we assume that the directors and their advisers are unaware that a distribution has been made unlawfully, there will be no entries in the company's tax return.

However, the financial statements filed online as part of the company's return may well show that the company's reserves are still in deficit at the end of the relevant period, even if no other disclosures are made. This should be picked up automatically by HMRC's systems and flagged accordingly. Likewise where the opening balance next year is in deficit (representing the 'relevant accounts' for the following year) and dividends are then paid notwithstanding. HMRC has been known to open enquiries on precisely these grounds.

The problem then arises that the company has filed an incorrect return, risking a penalty (under FA 2007, Sch 24). The calculation of the penalty arising will include the extra section 455 tax claimed to be due by HMRC, but notably without any relief for sums repaid or to be repaid under CTA 2010 s 458, after the usual nine month post-year-end window has expired (FA 2007, Sch 24, Para 5 (4)(b)).

Conclusion

There seem likely to be many more cases of 'illegal' dividends over the months and years to come, due to the impact of the Covid-19 pandemic, and its effects on trading profits and potentially on asset values going forward (although the latter may not always affect distributable reserves).

Ironically, while there may be many more such instances than directors or HMRC realise, HMRC will often be wrong if it simply assumes based on deficits reported in year-end returns. In the second part of the article, I'll examine why, and what companies can do if enquiries are raised.

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'Illegal' dividends and the pandemic (Part 2)

Lee Sharpe continues his review of what makes distributions unlawful and HMRC's approach to them.

In the first article, I looked at:

- What is a lawful distribution, so as to determine whether a distribution has been made unlawfully (or 'illegally').
- The company law treatment of amounts paid to shareholders who knew, or reasonably should have known, that they exceeded the lawful maximum.
- HMRC says that repayable amounts should be treated as loans to participators (where the company is 'close' within CTA 2010, Pt 10 (s 438 et seq.)).
- Under corporation tax self-assessment, it largely falls on the directors to 'tell' HMRC through the tax return when an illegal dividend has been made and to pay any additional section 455 tax due, etc.
- But HMRC will often open an enquiry into a company's tax return where it sees that reserves have fallen into deficit and dividends have been paid, but no corresponding section 455 tax entries have been made on the company's tax return.

In this second article, I shall consider in more detail:

- Was the distribution actually unlawful?
- When that should be tested and how the timing of events is critical; and
- What steps the company can take to mitigate exposure.

While company law can also hold directors personally liable for various transactions – particularly highlighted in insolvency cases – HMRC seems to focus only on shareholders and dividends (although of course there may well be overlap between the two classes, in owner-managed/family companies).

Was the dividend actually paid unlawfully?

The company is supposed to check a proposed dividend against its 'relevant accounts' as per my previous article.

For established companies, these will be the last set of statutory annual accounts. However, where they appear to show inadequate distributable reserves, the company can draw up interim accounts that 'prove' the company has since accumulated sufficient profits to support the proposed payment. Thus the precise timing of the payment in relation to the company's performance over the accounting period becomes of paramount importance.

The legality of a dividend is tested at the time it is made, not with the benefit of hindsight and events/losses that might not necessarily have been remotely foreseeable at the time the distribution was made.

In the context of the current pandemic, a company with (say) a September year end could have generated sufficient profits to support a dividend paid in late February 2020, comfortably before the pandemic's economic consequences could have been foreseen in the UK (not that we are necessarily any the wiser now!). Subsequent losses may well have resulted in the company having a deficit of distributable reserves by 30 September 2020; but that does not necessarily mean that interim dividends paid during the year since 1 October 2019 must have been paid unlawfully.

When are dividends actually paid?

HMRC's guidance states that the answer to this question depends on the company's Articles of Association, and suggests that usually it will be either an interim dividend proposed by the director(s) or a final dividend approved by the shareholder(s) (see HMRC's Company Taxation manual at CTM15205).

In line with the standard Model Articles, directors can propose and pay an interim dividend. Because the directors can vary or rescind an interim dividend at any point up to actual payment, it is deemed to have been paid only once and put unreservedly at the disposal of the shareholders. This means that, while HMRC accepts that payment can be made by way of crediting a shareholder/director's loan account in the company's ledgers, payment will have been made only once that adjustment has been effected; this can be problematic if the company relies on its books being written up by its advisers several months after the end of the year.

Usually, a final dividend is deemed to be paid immediately it has been formally approved by the shareholders because it is then legally enforceable – by its shareholders. However, if the shareholders' resolution sets a later date for actual payment (which is common for larger companies) then that later date will be the date from which shareholders can sue, and will be taken as the date of payment.

Losses after the dividend?

Clearly, by reference to CA 2006, s 830 and what it requires, a dividend paid in the year, but before the damaging losses etc. arose to put distributable reserves into deficit, should not be unlawful.

Even so, it can also be said that a company's directors have an ongoing duty to preserve the company's capital, and to take reasonable steps to ensure that the company is in a position to settle its debts as they fall due; so it is not necessarily the case that dividends may be paid without any regard for possible future events such as the potential local financial fallout from a looming global pandemic. But it would certainly seem arguable for dividends paid early in 2020 that owner-managed company directors could not reasonably have foreseen how bad things could get – or how quickly.

Nor will all businesses end up being similarly affected by the pandemic and the associated measures imposed by the government, such as social distancing or the temporary 'suspension' of property sales in late March; note that the latter example in particular was, in effect, an artificial or external adjustment to a market where the underlying demand (for housing) remains very strong.

What companies can do

Purely from a tax perspective, the problem with 'illegal dividends' is primarily the issue with the tax due temporarily from the company under CTA 2010, s 455. If a company is in serious financial difficulties (and negative distributable reserves would hardly suggest its outlook is rosy), having to pay 32.5% of any dividend deemed to have been excessive could be extremely difficult.

Readers will no doubt be aware that section 455 tax is ultimately refundable by HMRC, but that can take a long time – nine months and a day after the 'loan' is repaid to (or released by) the company.

However, the company does get up to nine months and a day from the end of its chargeable period to ensure that the loan is repaid or released, to prevent the section 455 tax being payable in the first place. This can give the company a range of options.

Repay the excess

1. Where the shareholder(s) have other sources of funding, they may be able to repay however much of the distribution was deemed to have been excessive.

2. Alternatively, where the business downturn is only temporary and if recovery is sufficiently swift, the company may be able to fund further dividends (or salary) to repay the excess dividend.

However:

- As already noted, care is needed to ensure that there is no doubt as to specifically which debt is being repaid because, in the absence of a prior allocation by the parties to the debt, HMRC could argue that it should simply be allocated to the oldest debt that the shareholder has to the company – which could be another liability entirely. This follows the principle set out in *Devaynes v Noble* (1816) 35 ER 781 – commonly known as 'Clayton's Case'.

- There are specific anti-avoidance provisions to combat 'bed-and-breakfasting' – making repayments only to withdraw them up to 30 days later, or (where the loans are large enough) any arrangements intended to withdraw the repayment although these are largely nullified where the repayment is made by crediting the account with an amount on which the participator has paid income tax, i.e. salary or dividend (CTA 2010, ss 464A-D; see also CTM61570, etc.)

Release/waive the excess

3. Where the company properly exercises a deed of release in relation to the amount repayable, it will likewise secure relief under CTA 2010, s 458. If exercised before the section 455 tax falls due, it will forestall the liability. However, care is needed to ensure that the release is not classified as earnings by HMRC.

Of course, if the company intends to fund the repayment by dividend or waiver, it will almost certainly need to have recovered from its previous financial difficulties; this can also broadly be relevant for salary.

Conclusion

A particular company's financial difficulties could derive from some highly specific circumstances – for example, where there was broad demand for a product but a failure in local supply, or the supply chain of another product consumed alongside. In a similar vein, who could have foretold in April that the skills and expertise of optometrists across the UK could effectively be replaced by a simple test of whether or not one could recognise a famous landmark at 200 paces?

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'Illegal' dividends (Part 3): Debt releases

Lee Sharpe looks at how 'illegal' (unlawful) dividends classified as loans to shareholders may be released to be taxed as a distribution, without being re-categorised as earnings by HMRC.

In the two previous articles, I have looked at so-called 'illegal' dividends and the implications from a tax perspective, for a 'close' company.

I shall now look at what happens if a distribution has been categorised as having been made unlawfully, and HMRC deems the money so received by shareholders to be owed back to the company. How would a release from that obligation be taxed?

Is it a loan?

In *Precision Dippings Ltd v Precision Dipping Marketing Ltd* [1986] Ch 447, it was found that the shareholder held the company's funds 'on constructive trust' for the company, after knowingly receiving an unlawful distribution.

It has been argued in the past that a 'constructive trust' is not equivalent to a loan, so CTA 2010, s 455 should not be triggered. But the 'loans to participators' legislation is widely drawn and widely interpreted, and HMRC will argue that any attempt at drawing a distinction becomes irrelevant once the shareholder appropriates the funds for their own purposes.

In order for a distribution to be unlawful and to be repayable, it must be the case that the recipient shareholders either knew, or should have known, that the distribution was unlawful, when so made. HMRC will generally assume that this applies wherever a shareholder is also a director, in close companies (see HMRC's Company Taxation manual at CTM15205).

However, 'innocent' shareholders will be treated as having received taxable dividends as usual, since they are not obliged to return the funds so received (and returning the payment offers no tax benefit, although HMRC seems to think it 'desirable to consider all such cases on their particular facts and merits'; perhaps HMRC can be encouraged to look at the bigger picture in enquiry cases?).

Assuming the shareholders are not able simply to return the funds, it is for the company to decide how to deal with the monies due. Assuming sufficient distributable reserves, a fresh dividend may be struck, effectively to replace the original, but with payment by adjustment to respective loan accounts. But the company could decide to write off the outstanding amounts, which might be preferable in circumstances where there are shareholders who are not in a repayment position, perhaps because they are not also directors.

Does the release of a loan count as earnings?

Let us assume that the agreement drawn up between the company and its shareholders in receipt of an unlawful distribution is legally effective, so as to absolve the shareholders of their obligation to repay the funds received. Certainly, one would expect this to be in the form of a deed, as the shareholders will be giving nothing in return (we shall come back to this later).

From an income tax perspective, ITTOIA 2005, s 415 will treat the release of a debt to a participator as a distribution. ITEPA 2003, s 189 prevents a charge to earnings under s 188 (see HMRC's Employment Income manual at EIM01490 or EIM21746).

Unfortunately, the situation is less clear-cut in terms of National Insurance contributions (NICs). Taken at face value, the guidance in HMRC's National Insurance manual itself might seem unequivocal:

'If the employer decides not to ask the employee to pay back any part of a loan and simply writes it off without seeking anything from the employee in return for giving up the debt, the amount written off becomes earnings and will be liable for Class 1 NICs at the time of write-off.' (NIM02210).

'...But you should note that a write-off of a loan is considered to be a payment of earnings liable to Class 1 within s3 and s6 Social Security Contributions and Benefits Act 1992.' (NIM12020)

Fortunately, HMRC's Corporation Tax manual sheds a little more light:

'As well as attracting a potential charge under ITTOIA05/S415, where the participator or associate is an employee, the amount released or written off will attract Class 1 NIC if it is remuneration or profit derived from an employment (section 3 (1) SSCBA 1992). This was confirmed in the First Tier Tribunal in *Fraser Ltd v HMRC* [2011] UKFTT 46 (TC).' (CTM616660; emphasis added).

It should be noted that SSCBA 1992, ss 3 and 6 do not act directly to treat a loan waiver as NICable earnings. Rather (and simplistically), section 3 merely says 'earnings' includes any remuneration or profit derived from an employment; and section 6 then just attaches a liability to Class 1 NICs, to 'earnings'. Therefore, in order to be NICable as earnings, the loan waiver must itself derive from the employment.

The Fraser case

The taxpayer lost in *Fraser Ltd v HMRC* [2011] UKFTT 46 (TC). However, it has been widely misinterpreted as providing authority that loan waivers are subject to NICs as earnings, without qualification.

The case involved a shareholder/director who had withdrawn sums through his director's loan account over the years, and the company wrote off the balance annually. The tribunal noted some regularity to the withdrawals and to the write-offs; also that the policy of loan waivers had effectively replaced a substantial salary. But note from the case:

'If the waivers were not in respect of Mr Fraser's shareholding then they were an emolument of his employment', and:

'[If the loan waiver is to be NICable] it must arise from the office or employment....while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as an employee.' (the latter being an extract from the earlier case of *Hochstrasser v Mayes* HL 1959, 38 TC 673).

Much turned on there being little to adduce in support of the taxpayer's contention that the write-off arose other than by way of employment. Notably, the waivers were approved by the board, rather than by the shareholders (probably because of a dispute with a minority shareholder).

Esprit Logistics: A bridge too far?

In *Esprit Logistics Management Ltd and Ors v HMRC* [2018] UKFTT 287 (TC), the taxpayer lost on whether or not the loan waivers were subject to income tax as earnings.

This should be rare, because HMRC generally accepts that ITTOIA 2005, s 415 will act to treat the write-off as a distribution, not earnings, as already noted. But the taxpayers were ambitious, having entered a packaged avoidance scheme that sought corporation tax relief for the loan releases as well.

On basic principles, that write-off expense must have been incurred wholly and exclusively for business purposes to be deductible. This generally rules out decisions made by shareholders, for the benefit of shareholders, but the taxpayers tried to argue that the write-offs were really in recognition of something broadly equivalent thereto, being the corresponding participators' accumulated services to the company or companies as employees, so should be allowable.

While a complex case, it could perhaps be summarised that, unfortunately for the taxpayers, this attempt fatally undermined the idea that a loan waiver must be effected in return for nil valuable consideration – if the release is in exchange for something else, it is not really a 'gift'. In this case, the tribunal concluded that the relationship between the loan waivers and the value of unpaid remuneration 'owed' to the participators in the scheme was so close, they were earnings, and taxable as such, rather than waivers taxable as distributions.

Even so, HMRC must have been concerned that such schemes might ultimately obtain business tax relief, because the government introduced legislation specifically to prevent that in FA 2010, s 43 (introducing CTA 2009, s 321A).

Practical tip

While the risk of a loan release being taxable as earnings subject to income tax is generally considered to be low, there are many advisers who seem to work on the assumption that a loan release will be generally be subject to NICs as earnings. I would contend that this is what HMRC would have you believe, but this is not supported by case law, or statute – in fact, the *Fraser* case is arguably more of a help than a hindrance.

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