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Declaring dividends – dangers for directors

Accountants for small businesses often encourage a relaxed attitude to money coming out of the company to the owner / managers, along the lines of "don't worry we will sort it out at the end of the year". What then happens is that monthly payments are made and the remuneration is allocated between salary and dividends in the most tax efficient way at the end of the financial year.

Paying dividends

It should not be forgotten that there are certain formalities with regard to the payment of dividends which need to be observed at the time that the payments are made. First, the company must have sufficient distributable reserves and any dividend must be paid by reference to relevant accounts showing this. Secondly, the directors must pass a resolution approving the dividend before it is paid. These formal steps are often omitted.

What typically happens is that monthly payments to directors are simply treated as dividends when they are paid and re-classified as salary in the event the company does not ultimately have sufficient profits. In most cases this will not be a problem, as nobody will challenge it, however in certain circumstances this can be a very dangerous approach for directors to take.

In strict legal terms, a dividend paid when the company does not have sufficient distributable reserves is unlawful. Making such a payment breaches a directors fiduciary duties. Re-classifying the payment at the end of the financial year as being salary does not change that position.

If the company goes into liquidation then unlawful dividends can be clawed back under s.847 of the Companies Act 2006. In addition, if there has been a cavalier attitude to such payments over a period of time there is also the risk of disqualification proceedings. It is not a defence for the director to say that they relied on the advice of their accountants.

Summary

In summary, directors should treat with caution the suggestion that remuneration can be paid out and then allocated between salary and dividends in due course. In most cases there will be nobody with an interest in challenging things. However, a liquidator or an angry shareholder (for example one with a different class of shares who did not receive a dividend) might raise a claim and if they do, directors who have paid an unlawful dividend will find themselves legally very exposed.

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