Tax planning and unlawful dividends

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Julie Butler explores unlawful dividends in the context of tax planning in the current economic climate and the proposed changes for 2010.

With the problems of recession closing in around most small businesses the problem of the "super higher rate" of tax from 2010 for individuals might be the least of their worries.

Looking ahead to 2010, an interesting set of choices will arise depending on whether someone is a higher rate taxpayer or even a new "super higher rate" taxpayer from 2011. From 2010, the owner of a small business who earns over £100,000 will see his or her personal allowance being tapered away until he or she reaches £140,000, when the personal allowance will disappear entirely. The rate of National Insurance Contribution (NIC) is also increasing by 0.5 percent from 2011. "Withdraw quick" for not doing this leaves those on £100,000 with a marginal tax rate of 61.5 percent.

The tax adviser therefore, has to build into current tax planning the opportunity of paying 40 percent tax now before the increase in tax rates i.e. in the year to April 5, 2010 and onwards, and to maximise dividends at 40 percent whilst it can be enjoyed.

However with the Balance Sheet write downs that might or will be evolving from the recession (e.g. stock at the lower of cost and net realisable value (NRV), where NRV has dropped considerably), thought will have to be given to ensuring that the Balance Sheet is positive.

I. Borrowings

With the base rate at 0.5 percent there are arguments to say that if the business can obtain borrowings against say high work in progress then provided the business is solvent (not insolvent) then maximum drawings should be taken via dividends for individual tax planning. How foolish increasing borrowings may sound but what of the tax planning?

II. Liability to repay unlawful dividends

In a recent case, *Paycheck Service No. 3 Limited, Revenue & Customs Commissions v Holland* (2008) All ER(D) 319 (June 24, 2008), the respondents were directors of Paycheck Service No. 3 Limited (PS) which they operated as their trading company. The directors each held 50 percent of the issued shared capital. PS Limited itself held 100 percent of the issued shared capital of PDS Limited and PSS Limited and the respondents were each appointed as directors of PDS and PSS. All three companies, together known as the composite companies, relied on an extra statutory concession in relation to the calculation of corporation tax.

In April 2001, Revenue & Customs claimed that the composite companies might not be entitled to rely on the extra statutory concession. While the respondents took legal advice, they were never advised that the composite companies should stop paying dividends. The Revenue subsequently commenced proceedings against the respondents, seeking to make them responsible to meet the further liability for the higher rate of corporation tax payable by the composite companies. The Revenue's case was that by causing the composite companies to continue to trade and pay dividends, with knowledge that the composite companies were then rendered insolvent given the additional tax liability, the respondents were in breach of their duties as directors, i.e. they could not pay illegal dividends.

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The Judge held that from the time the directors received legal advice about the tax position, there was no reasonably held belief that the Revenue's claims to additional corporation tax would be defeated and accordingly, from that date onwards, the interim accounts ought to have made provision for the additional tax liability. In the circumstances, any dividends paid after that date had been unlawful and were liable to be repaid. Prior to receiving legal advice, there were reasonable grounds for the continuation of payment of dividends. However, once the liability was known, dividends should have stopped.

The fine balance between tax planning, directors' duties and cash flow management is made clear by tax planning to avoid the "super higher rate of tax", cash flow management and prudence together with the risk of trading insolvently is shown in this case.

At a practical level this is another example of the need for the accounts team to talk to the tax team to produce management accounts and ensure close liaison with the client.

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