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Dividends, taxed profits and the Director's Loan Account

Taxed profits and the dividend pool

When a company makes a profit in a financial year, it has to pay corporation tax on those profits.

What remains is known as the 'taxed profit' or 'reserves' and is available for distribution to shareholders as dividends.

Any taxed profits not voted as dividend get carried forward to the next year – as a 'dividend pool' that can be dipped into in future years. If the company makes a post-tax loss, then this will reduce the dividend pool.

So if the company makes a year #1 profit of	£50,000
It will have to pay corporation tax of	£10,000
Leaving available for the dividend pool	£40,000
If the dividends are voted as	£25,000
Then the balance carried forward in the dividend pool is	£15,000

If the trade is the same in year #2 then we'd still have:

The company makes a profit of	£50,000
It will have to pay corporation tax of	£10,000
Leaving available for dividend pool	£40,000
But we also have brought forward from last year	£15,000 in the dividend pool
So the maximum available for dividends in year 2 is	£55,000

Once again, anything not paid as dividends gets carried forward in the dividend pool to future years.

So: the dividend pool (which is shown on at the foot of a Balance Sheet after 'Shares' and may be called 'Profit and Loss' or 'Reserves') is the accumulated taxed profits of the business less dividends paid, up to the date of the Balance Sheet and is an amount available to be voted as dividends to the shareholders. It has already suffered corporation tax.

The Director's Loan Account

When the company votes a dividend it doesn't have to immediately pay the dividend out in cash; it can instead record it against the Director's Loan Account ("DLA") – the 'tab' account which the director runs with the business.

It's possible that when a dividend is voted, the DLA may already be overdrawn because of private expenses paid by the company for the director – or cash or similar drawings. In those cases the dividend will offset that overdrawn balance and any excess will be shown as if it were a loan from the director to the company – and this is available to be drawn at any time by the director without there being any further personal tax implication; it is simply repayment of a loan.

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When a company pays dividends to its shareholders there is a 'tax free' element from which they can benefit and above which tax is applied at different rates depending on their overall income.

For this reason it is necessary to review an individual's personal tax situation as part of considering voting dividends; if a higher dividend isn't required for personal reasons, the best idea can be to vote dividends to the maximum that the individual can take without having to pay any additional personal tax.

As explained, a company doesn't have to distribute all taxed profits in any year as dividend – it may decide it needs to keep funds to develop the business or there may be a decision not to distribute dividends that give the shareholder a personal tax liability.

In some cases, dividends are voted to maximise income without incurring a personal tax liability, with the dividend pool left in the company simply building up for future years when, for example, another shareholder (e.g. spouse) might be given shares so that dividends can be split between two individuals both benefitting from a 'tax free' allowance.

The dividend pool (Reserves) might therefore build up over many years – it is still available for dividends in future years and the timing of their payment may simply be dictated by the tax position – or cash requirement – of the shareholders.

The Director's Loan Account might therefore start with a balance in favour of the director – because of goods and assets or goodwill introduced to the new company; it then increases with dividends recorded against it each year or by funds introduced by the director – and is reduced by money drawn by the director or personal expenses paid by the company.

The balance at the end of one year on the DLA rolls forward to be the opening balance next year. The timing and amount of drawings from the DLA do not affect the personal tax return – it's the timing and value of dividends (which go into the DLA) which affect the tax return and they are entered on it.

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