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## **Opinions on allocation of profit carried forward to dividends**

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# Opinions on allocation of profit carried forward to dividends

## Abstract

*In our opinion, the allocation of profits carried forward to dividends complies with the legal requirements in this field, as long as these results arise from current profits of previous financial years. However, an adverse aspect for companies is related to taxation of this subsequent distribution, due to the risk that tax authorities might reclassify this operation and, implicitly, apply penalties for late payment of dividends, starting with the 1<sup>st</sup> of January of the financial year following the one in which the carry forward of the profits of the previous financial year has been approved, and until the payment of related tax.*

**Key Words:** *result carried forward, dividends, general meeting of shareholders, dividend tax*

## Introduction

In 2009, companies' administrators have raised a series of questions on how to counteract the effects of the American financial crisis on economic activities in Europe, in general, and in Romania, in particular. Among these questions are the following:

- 1) can companies reconsider the decision to distribute dividends from the profits of the previous financial year, in general, and 2008, in particular?
- 2) can companies reconsider the decisions to allocate net profits to results carried forward from previous financial years (net profit carried forward)?

Although the two questions are closely related, we will refer below to the second question.

## 1. Background

In previous financial years, companies have recorded substantial profits due to general economic growth in Romania. In this respect, the support of investment programmes required a series of funds that shareholders agreed to temporarily make available to companies, but not as net uncollected dividends converted into interest-bearing loans, but through net retained results, so that the company benefits from a higher volume of funds to support investment programmes, equal to the size of dividend tax which the company would have paid for a dividend distribution.

Furthermore, working capital was insufficient to finance current operations, and retained profits (carried forward) represented the handiest financing source for management. Another solution would have been to resort to bank loans, but, in the present circumstances it is difficult to anticipate the financial impact of costs involved by such an approach (fees, interest expenses, commissions, etc.).

Also, if profits would have been allocated to dividends, in many cases the amounts required for their payment would have been generated from collections of the financial year following the one for which they were distributed, subject to the general meeting's approval.

The situation described meets quite frequently in limited liability companies (sometimes micro-companies), where the administrator - shareholder postpones payment of dividends by carrying forward the profits of the financial years, due to lack of liquidities combined with the "convenience" of not paying dividend tax, withheld at source at the rate of 16%.

Administrators raised the question if a decision of the general meeting of shareholders for carrying forward the company's net profit from previous financial years could be reconsidered in order to allocate these results carried forward to dividends?

## 2. Current legal situation

Art. 111 paragraph 2 point a) of Company Law provides that the general meeting of shareholders (for joint stock companies) is required "to discuss, approve or amend the annual financial statements based on reports prepared by the board of directors, respectively the management and the oversight board, internal auditors, or as appropriate, financial auditors, and *to determine the dividend*". Also, article 194 paragraph 1 letter a), provides that, among other main obligations, the general meeting has to approve the annual financial statements and to decide the distribution of net profits (for companies with limited liability).

The size of dividend in the process of distributing net profits fluctuates within a limited interval between zero and the level of distributable profits.

In other words, the publication of the decision of the general meeting by means of Trade Register and Official Gazette has the effect that the decision becomes opposable to the associates/shareholders who were absent from the meeting (those who were present and voted against or abstained are presumed to be aware of the decision taken), as well as to third parties.

Even if Company Law no. 31/1990 does not expressly provide that the general meeting of shareholders could reconsider the decision (decisions) of previous years, in general, it is appreciated<sup>1</sup> that "revoking the previous decision is possible if it is done in compliance with the principle of symmetry of legal acts and if this does not prejudice the rights of third parties. Thus, if the symmetry principle is applied, the ordinary general meeting, which is competent to decide on company's profit distribution, might also decide to revoke the previous decision, subject to the same legal or statutory quorum and majority conditions."

According to article 132 paragraph 1 of Company Law no. 31/1990, the decision that complies with the law and the company's by-laws is binding (*pacta sunt servanta*) and, therefore it is opposable as such to all associates, including those who were absent or voted against. On the other hand, general meeting's decisions that are violating the law or the company's by-laws can be disputed in court by means of nullity / annulment actions introduced by those associates who voted against and asked for their vote to be recorded in the meeting's minute, as well as by those who were absent. Also, based on article 61 of Law no. 31/1990, the decisions may be contested by any prejudiced creditors (including the state, through its institutions).

### **3. Is it legal to reconsider a decision regarding carry forward of profits?**

In the case discussed, respectively reconsideration of a decision establishing:

- either a zero dividend and full carry forward of profits,
- or partial allocation of net profits to dividends,

due to lack of liquidities, at a later stage, when the company has available liquidities (situation determined by investment efforts, financial problems, etc.), meaning that the new decision decides to fully or partially allocate profits carried forward to dividends, leads us to a solution for the conflict between social interests and personal interests of shareholders or associates.

Article 136<sup>1</sup> of Company Law no. 31 provides that "shareholders must exert their rights in good faith, by considering the legitimate rights and interests of the company and of the other shareholders." Based on this law, we appreciate that the importance of company interests and the role of *affectio societatis* have decreased. *Affectio societatis* involves subordination of shareholders' individual interests to the company's general interest. This principle applies not only to share capital companies (joint-stock companies), but also to joint ventures (*intuitu personae* and *intuitu pecuniae*), limited liability companies. Our assertion is based on the fact that the law uses conjunction "and", what makes us believe that shareholders' interests benefit of the same protection as company's interests.

The provision of article 131<sup>1</sup> was introduced in our commercial law in the context of implementing corporate governance, following the example of other Member States based on the Anglo-Saxon model concerning corporations. According to the French doctrine, the main principle of corporate governance is the following: share capital companies must be managed in the interests of

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<sup>1</sup> Lavinia Tec – "Distributed Dividends - Financing Source in Times of Crisis", Romanian Tax Magazine no. 3/2009, page 4.

shareholders. In this context, *affectio societatis*, which both Romanian and French doctrines have qualified as behavioural norm, seems to be incompatible with *corporate governance*<sup>2</sup>.

The set up of a company aims firstly to fulfil an activity for the financial benefit of the investor – shareholder or associate, and the company's by-laws represent an investment agreement. Investors, individuals or companies, associate themselves not for altruistic ideas and charity or generosity, but for gaining from investments and implicitly, for disposing of these gains at anytime. The procedural regime for profit distribution is covered by article 117<sup>2</sup> paragraph 1 and article 153<sup>5</sup> paragraph 2 of Company Law no. 31, according to the management system of joint-stock companies (unitary or dualist): "The annual financial statements, the annual report of the board of directors, respectively the report of management and the one of the oversight board, as well as the proposal on dividends distribution, shall be made available to the shareholders at the company's headquarters, at the date of calling in the general meeting", for the unitary system, respectively "The management submits to the oversight board its detailed proposal regarding the distribution of profits resulted from the balance sheet of the financial year, which it intends to present to the general meeting", for the dualist system.

If the proposal for allocation to dividends was approved by the ordinary general meeting of shareholders/associates, according to article 67, dividends shall be paid "within the time limit set by the general meeting of shareholders or, as the case may be, the deadline set by special laws, but no later than 6 months from the date when the financial statements for the closed financial year were approved."

Based on the legal provisions mentioned above, we can assert that the proposal for dividends distribution must be approved in the same general meeting that reviews and approves the financial statements for the financial year ended. However, this interpretation does not restrain the general meeting of shareholders/associates to decide distribution of zero dividends (no dividends will be distributed), although there is a distributable net profit, or to allocate the profit partially to dividends, partially to other reserves, and partially to results carried forward (retained profit), by taking into account the company's actual situation (e.g. lack of liquidities) and other circumstances (e.g. economic crisis) or legal restrictions (economic prudence), such as:

- "Dividends will be distributed only from profits derived according to the law."<sup>3</sup>;
- "If there is a loss in net assets, subscribed share capital will be completed or reduced before any profit distribution or allocation."<sup>4</sup>;
- "If set-up costs were not fully depreciated, there will be no profit distribution, unless reserves available for distribution and profits carried forward are at least equal with the outstanding costs."<sup>5</sup>
- "If development costs were not fully depreciated, there will be no profit distribution, unless reserves available for distribution and profits carried forward are at least equal with the outstanding costs."<sup>6</sup>

#### 4. Accounting and tax treatment

According to article 67 paragraph 3 of Company Law no. 31/1990, the source for setting-up dividends consists of "profits derived according to the law", without distinction between current net profits (of the previous year) or net profits carried forward. "In the lack of financial statements or contrary to their results, the founder, administrator or legal representative of a company, who receives or pays dividends, in any form, from fictive profits or profits which could not be distributed, shall be punished with imprisonment from 2 to 8 years."<sup>7</sup>

Also, according to article 19 paragraphs 1 and 2 of Accounting Law no. 82/1991, accounting profit or loss is determined cumulatively, from the beginning of the financial year, and the final result of

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<sup>2</sup> *Ibidem*, page 5.

<sup>3</sup> Article 67 paragraph 3 of Company Law no. 31/1990.

<sup>4</sup> Article 69 *Ibidem*.

<sup>5</sup> Point 72, paragraph 2 of Accounting Regulations in Accordance with the 4<sup>th</sup> Directive of the European Economic Communities Approved by Order of the Ministry of Finance no. 1752/2005.

<sup>6</sup> Point 75, paragraph 3 *Ibidem*.

<sup>7</sup> Article 272<sup>1</sup> paragraph 2 of Company Law no. 31/1990.

the financial year is set at the end of the financial year (in Romania, the financial year usually is the calendar year, and consequently, closing date is 31 December).

"Profit distribution shall be recorded in accounting according to its destinations, after the approval of the financial statements."<sup>8</sup> Therefore, allocation of net profits is left to the general meeting of shareholders, and it is not necessary profits to be distributed in full to associates/shareholders. The decision of shareholders/associates to give up, at least temporarily, to one of their rights, does not restrain them to reconsider their initial decision, subject to the conditions required by law in respect to jurisdiction of general meetings (*qui potest plus potest minus*).

Legal distributions that may be approved by the ordinary general meeting / meeting of shareholders / associates are:

- amounts allocated to reserves (legal reserves and other reserves);
- amounts allocated for covering losses from previous years;
- dividends;
- other allocations.

The difference between total net profits of the year and total distributions performed represents retained profits (which, obviously, may include also profits not distributed as dividends), on which the general meeting did not decide in terms of destination. Therefore, there is a distinction between profits distributed to shareholders (dividends), profits representing final allocations (covering losses from previous years, reserves and other allocations) and profits on which there is no final decision yet (result carried forward # 117 Result carried forward).

In terms of tax treatment, the document by which the ordinary general meeting / meeting of shareholders / associates decides not to distribute the full net profit, followed by a subsequent distribution, in another financial year, might be considered an act made for tax purposes. In our opinion, this act might be reclassified under article 11 paragraph 1 of the Fiscal Code: "In determining any tax amount within the meaning of this code, the tax authorities may disregard transaction which does not have an economic purpose or they may reclassify the form of a transaction to reflect its economic substance." The carry forward of the net results of a financial year, followed by its distribution as dividends in another financial year, may be reclassified by tax authorities as a distribution already from its postponement (e.g. if the company operated normally, had liquidities, etc.) and tax authorities are entitled to calculate penalties for late payment of dividends (currently, 0,1% per day) starting with the 1<sup>st</sup> of January of the financial year following the one in which the general meeting of shareholders took place, which has approved the carry forward of profits (e.g. 01.01.2009 for net profits carried forward related to the financial year ended as at 31.12.2007), and until the payment of the related tax (thus, considering another fiscal situation). Of course, there will be a different situation if it can be proved that such behaviour of shareholders/associates has/had an economic substance, respectively maintaining the company's activity, and that ongoing concern prevailed over the shareholders'/associates' interests, who have acted "in good faith", within the meaning stated at article 131<sup>1</sup> of Company Law no. 31/1990 (e.g. in economic crisis periods, limited access to bank loans, etc.).

## Conclusions

Subject to the quorum conditions required to be legal, a new ordinary general meeting / meeting of shareholders / associates may reconsider in terms of distributing dividends from results carried forward from previous financial years, with proper recognition of the operation in the financial year in which the distribution took place.

However, depending on the actual situation in which profits have been carried forward (not being distributed in the financial year following the one for which the distribution is made), it is likely that tax authorities will treat the operation as a form of avoiding payment of dividend tax, and they may want to calculate late payment penalties (*accessorium sequitur principalem*). The company which was required to withhold and to pay the dividend tax to the state budget has the obligation to prove the contrary, respectively the actual tax status<sup>9</sup>.

<sup>8</sup> Article 19 paragraph 3 of Accounting Law no. 82/1991.

<sup>9</sup> Article 65 paragraph 1 of Government Ordinance no. 92/2003 regarding the Fiscal Procedure Code.

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4. \*\*\* Law no. 31/1990, Company Law
5. \*\*\* Law no. 82/1991, Accounting Law