

ppi 201502ZU4645

Esta publicación científica en formato digital es continuidad de la revista impresa
ISSN-Versión Impresa 0798-1406 / ISSN-Versión on line 2542-3185 Depósito legal pp
197402ZU34



CUESTIONES POLÍTICAS

Instituto de Estudios Políticos y Derecho Público "Dr. Humberto J. La Roche"
de la Facultad de Ciencias Jurídicas y Políticas de la Universidad del Zulia
Maracaibo, Venezuela



Vol.39

Nº 70

2021

Legal Aspects of Dividend Payment in a Limited Liability Company

DOI: <https://doi.org/10.46398/cuestpol.3970.07>

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Abstract

The objective of the study was to identify forms, main objectives and regulatory measures that can improve the development of the legal regulation of dividend payments in a limited liability company. The study involved three methods: direct observation, comparison, and analysis of the content of documents that provide legal regulation of dividend payments at the state and interstate levels. Eight important factors influencing dividend policy are presented. The success of business activity depends directly on the regularity of profits and the amount of capital of the company, while it is inversely dependent on the regularity and size of dividends. It is concluded that the type and form of dividend policy is partly governed by the rule of law and partly determined by non-legal business factors. An optimal dividend policy means that there must be an appropriate balance between the payment of current dividends and the future growth of the company's profits. In this case, the procedure established by law and the sequence of shares preceding the payment of dividends indicates the partial entrepreneurial freedom of the participants in this case.

Keywords: determining factors; dividends; dividend payments procedure; dividend policy; limited liability company.

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Aspectos Legales del Pago de Dividendos en Una Sociedad de Responsabilidad Limitada

Resumen

El objetivo del estudio fue identificar formas, objetivos principales y medidas regulatorias que pueden mejorar el desarrollo de la regulación legal del pago de dividendos en una sociedad de responsabilidad limitada. El estudio involucró tres métodos: observación directa, comparación y análisis del contenido de los documentos que proporcionan la regulación legal del pago de dividendos en a nivel estatal e interestatal. Todo indica que, el éxito de la actividad empresarial depende directamente de la regularidad de los beneficios y la cantidad de capital de la empresa, mientras que es inversamente dependiente de la regularidad y el tamaño de los dividendos. Se concluye que, el tipo y la forma de la política de dividendos se rige en parte por el estado de derecho y en parte está determinada por factores comerciales no legales. Una política de dividendos óptima significa que debe haber un equilibrio adecuado entre el pago de dividendos actuales y el crecimiento futuro de las ganancias de la empresa. En este caso, el procedimiento establecido por ley y la secuencia de acciones que preceden al pago de dividendos indica la libertad empresarial parcial de los participantes en este asunto.

Palabras claves: factores determinantes; dividendos; procedimiento de pago de dividendos; política de dividendos; sociedad de responsabilidad limitada.

Introduction

Corporations have existed for many years, but a limited liability company (hereinafter — LLC) is a fairly new type of business that has proved popular among small business owners (Business Jet, 2019). According to national statistics in 2020, the number of LLCs was 50% in the total number of legal entities —35 — in Ukraine (Ukrstat, 2020).

The purpose of all enterprises is to make a profit by its founders, and therefore dividend payment is a guideline in the activities of LLC and its owners. If the results of the company's activities show that the past year was successful, the General Meeting of participants may decide either to pay dividends or to accumulate funds for further business development (Captain Contrat, 2017).

When LLC members have a corresponding share in their companies, they profit from this share differently and face very different tax problems (Payet, n. d.). Despite the fact that there is no definition of “dividends” in the

legislation governing the activities of LLC, dividends (from Latin *dividendus* – the one that is subject to division) is called the part of the company's profits distributed among its founders (Pomulieva and Remenyuk, 2017).

It turns out that it is not possible to collect dividends for the reporting period in court if the relevant decision of the General Meeting of LLC participants was not made. In this case, it is possible to apply to the commercial court to make a decision on the collection of dividends, if there is a relevant decision of the General Meeting of the company's participants. It is possible to demand recovery of the amount of debt incurred, taking into account the established inflation index for the entire period of delay and an additional 3% per annum of the overdue amount in court only (Supreme Economic Court of Ukraine, 2016).

The study will provide further development and improvement of guarantees at the legislative level on the fairness and expediency of regular payment of dividends in LLCs, taking into account the experience of other countries.

In the context of a global pandemic associated with an increase in human morbidity caused by the previously unknown to mankind Covid-19 virus, the company's physical business contacts have sharply reduced. Quarantine restrictions have affected the decline in companies' profitability, including LLCs. For the stated reason, as well as the fact that the LLC is characterised by limited liability of its members, the amount and regularity of dividend payment has decreased. Therefore, some legal aspects related to their dividend payments have become relevant in business.

1. Literature Review

At the national level, the procedure for deciding on the dividend payment in LLCs is set out in the Law of Ukraine "On Limited and Full Liability Companies". In particular, the General Meeting of participants considers the distribution of the company's net profit and dividend payment. Chernenko (2019) notes that the payment of dividends depends not only on the established dividend policy, but also on the owners' willingness to pay them.

Refusal of periodic dividend payments is justified by reinvestment of the received profit in the company's further development. The main factors influencing the company's dividend policy are: profitability, structure of past dividends, legal norms, financial leverage, investments, etc. (Murekefu and Ouma, 2012). A group of scholars, Pinto and Rastogi (2019) found that size and profitability have a significant positive effect on dividend policy. Business risk and debt have a significant negative relationship with dividends, and therefore it is justified to adhere to a stable dividend policy.

The freedom to do business is enshrined in Article 16 of the Charter of Fundamental Rights of the European Union, which has become a legally binding document, with the same legal force as international treaties (Usai, 2019).

Spilnyk and Zahorodna (2014) note that the term “dividend” for participants is income, and for the company it is a payment. Sondakh (2019) found that the company’s policy of retaining dividends negatively and significantly affects the company’s value. Investors prefer companies that distribute dividends because they are confident in the return on their investment. There are four types of dividend policy: regular dividend policy; stable dividend policy; irregular dividend policy; lack of dividend policy (Borad, 2014). Dividend policy is a reflection of the company’s financial performance (Thakur, n. d.).

Due to the high rates of taxes levied on dividends, investors are often reluctant to receive dividends and leave the accumulated profits for the company’s further development (Breaking Down Finance, n. d.).

The law allows members to receive an interim dividend payment by the end of the reporting year. In case of limited liability companies, interim dividend payment may be submitted by the manager/head of the company (if the company has a supervisory board – upon its approval). If the report after the payment of interim dividends shows that the company is not capable to pay dividends, the interim dividends shall be payable. In particular, this clause protects the company’s creditors and suppliers (Kertész, 2016).

Legal systems limit the rights of company members to profit by creating a special reserve fund or limiting the resources (profits) to be distributed (Simčina, n. d.).

The aim of the study: Identification of ways, main objectives and regulatory measures that can improve the development of legal regulation of dividend payment in LLCs.

Research objectives:

- determine the procedure, amount, and possible restrictions in the dividend payment in LLC.
- review the foreign experience of legal regulation of dividend payments in LLC.
- formulate proposals to increase the efficiency of regulation of dividend payment in LLC.

The research hypothesis is in the form of statements about concepts that can be true or false if they relate to an empirically observed and verified phenomenon.

Based on the empirical ground and research methodology, the hypotheses are formulated as follows:

- a) the dividend payment policy in LLC affects the company's value and success.
- b) the tax policy of dividends significantly affects the frequency and willingness to receive dividends by the company's members.
- c) dividend payment in LLC is determined by legal norms only, and there are no other, informal factors that affect the frequency and amount of dividend payment.

2. Methodology

The main empirical ground of the study is collected using three methods: direct observation, comparison, and analysis of the content of documents that provide legal regulation of dividend payment in LLC at the state and interstate level. In the course of *direct observation*, laws, documents and regulations governing the procedure and features of dividend payment to LLC participants were identified. The grounds, conditions, procedure and frequency of dividend payment at the national and interstate levels have been established. The significance and priority of regulatory documents that determine the dividend payment procedure in the company are provided.

In most cases, the frequency of dividend payments is determined by the company in the constituent documents or in the decision of the General Meeting based on the results of the reporting period. If the charter stipulates the payment of dividends at the end of the reporting year, the decision to pay intermediate dividends without making appropriate changes to the constituent documents will be a direct violation of the charter's provisions.

The review of modern scientific opinion found that in addition to formal rules and procedures, there are many other factors that determine the frequency of payment and the amount of dividends.

Besides, a study of current legislation found that the procedure for distribution of profits in the form of dividends is quite flexible and formally regulated by the company's charter, while informally depends on dividend policy.

When using the method of *comparison*, it is established how the countries provide guarantees of dividend payments in LLCs. In times of crisis or in other unforeseen cases the company will not be able to ensure timely dividend payment without an adequate amount of capital reserve fund.

Comparative analysis shows that the company's profitability is the main factor determining the dividend policy. However, the focus on long-term profitability, combined with capital reinvestment will extend the company's life cycle.

The *analysis of the content of various documents* involved the information posted on social networks, scientific journals and on news websites. The current volume and sources regulating the dividend payment procedure in LLCs was established. The tendencies, objectives and directions of legal regulation of dividend payment in LLCs are studied.

3. Results

A LLCs is a type of business association. Therefore, LLCs shall create a reserve fund in in the amount established by the constituent documents, but not less than 25 percent of the company's authorised capital. The main feature of dividends paid in LLCs, in contrast to open joint stock companies, is that they are not paid regularly (Verkhovna Rada of Ukraine, 2018a). In France, each company must have a "reserve" of at least 10% of its capital. Until this threshold is reached, it must reserve 5% of its profits annually (Captain Contrat, 2017). In the United Kingdom, the reserve fund for dividends is set at 15% (MRSC, 2021).

The authorities typically discuss the need for contingency funds in the context of securing future capital expenditures, debt obligations, emergencies, economic downturns and imminent contingencies that may cause financial difficulties. It is important to clearly define the intended use of each reserve of the fund and the balance of funds created by the organisation. According to Link Group Dividend Monitor, in 2020 investment funds increased the amount of dividends by 4.2%, despite the fact that payments in the UK decreased by 38% and global dividends — by 12.2%. In the midst of the Covid-19 crisis, more than three-quarters of the world's trusts increased dividend payments. This success is due to the significant reserves of investment funds. Income reserves are an important feature of investment funds, they can be distributed in the future. This is how they differ from open investment companies, which have to pay all their dividends each year (Palmer, 2021). Thus, the company's reserve fund is extremely important in unforeseen cases, such as the economic crisis, debt repayment upon court decision, etc.

It should be noted that there is some uncertainty as for the terms for dividend payment. In particular, in accordance with Part 4, Art. 26 of the Law of Ukraine "On Limited and Full Liability Companies", dividends shall be paid within a period not exceeding six months from the date of the decision on their payment, unless otherwise provided by the company's

charter or the decision of the General Meeting of participants (Verkhovna Rada of Ukraine, 2018b). These rules recommend the payment of dividends based on the decision of the General Meeting, they leave these bodies wide freedom in determining the date of payment, and most importantly — they do not determine the consequences of not specifying this date (Russell Bedford Poland, 2018). As mentioned above, the only civil consequences for LLCs are inflation indices and an additional 3% per annum of the overdue amount. However, as a result of the payment of unforeseen expenses in the form of payment of interest on dividend arrears upon a court decision, the law excludes the obligation to include these amounts in those subject to taxation (Humanitarian Portal, 2021).

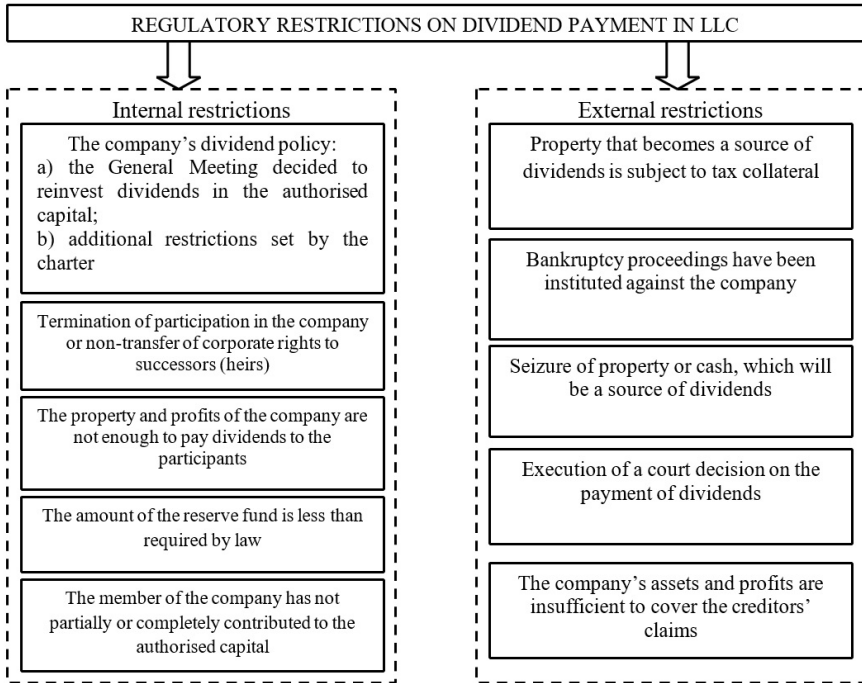
Under national law, dividends are paid out of net income for any period that is a multiple of a quarter, unless otherwise provided by the charter (Bartlett, 2020). Intermediate dividends can be distributed among company members without knowing how much final profit the company will receive. Such a distribution is risky if the deposit remains higher than the actual profit (Janquert, 2020).

In addition to the regulations and rules that determine the dividend payment procedure in LLC, there are a number of legal restrictions and prohibitions which may prevent dividend payment. Based on the results of the analysis of the Tax Code, the Code of Bankruptcy Procedures, the Law on Limited Liability Companies (Verkhovna Rada of Ukraine, 2018a; 2018b; 2019), as well as considering the entities introducing such restrictions, we propose to present them schematically in Figure 1 (Regulatory restrictions on dividend payment in LLC). Without taking into account such restrictions, it is not possible to make an informed legal decision on dividend payment.

Dividends are in fact a form of profit, so they are subject to the relevant taxes, fees and other mandatory payments. For example, the main advantage of LLCs over corporations in the United States is that LLC owners are not subject to double taxation (Murray, 2021). The concept of double taxation does not apply to LLCs. Thus, despite the fact that the LLC as a legal entity is not subject to taxation, the share of a foreign partner or participant of the LLC or actually related income of the LLC is taxed (Schneidman, 2017).

The national system of taxation of LLC is a bit more complicated. The founders of LLC can be both individuals and legal entities, both residents and non-residents. Nevertheless, in addition to the founders, the LLC also has a burden of paying taxes under the general or simplified system.

Figure 1. Regulatory restrictions on dividend payment



Source: own elaboration.

To arrange the type and amount of dividend encumbrances, we propose schematically present the types of taxes, payments and the amount of interest on dividends in LLC in Table 1. The information given in Table 1 is the author's own development and relates to taxes and mandatory payments related to the cash amount of dividends. At the same time, when paying dividends in kind, it is also necessary to pay additional VAT in the amount of 20%. LLCs paying single tax are not entitled to pay dividends in non-cash form, because according to paragraph 291.6 of the TCU they are allowed to make payments for shipped goods only in cash. The form of such payment can be cash or non-cash.

Table 1. Taxes and dividend payments in LLC (author's own development)

		Who pays taxes and fees					
		LLC Individual (resident and non-resident) Resident			LLC participants		
		Legal entity			Non-resident		
Type of tax, payment	Income tax	Advance payment when paying to resident legal entities	Repatriation tax for non-resident legal entities	Personal income tax	Military fee	Income tax	
General tax system	The size id determined by the TCU						The size is determined by the laws of the country of the company's registration
	18%	18% (except in cases of exemption of legal entities from payment)	15% (5% according to the international agreement, provided that the non-resident legal entity owns more than 20% of the LLC's property)	5% (18% when the fixed amount of dividends is paid)	1.5%	18%	
Simplified tax system	5% (VAT excluded)	-	-	9% (18% when the fixed amount of dividends is paid)	-	5% (VAT excluded)	-
	3% (VAT including)	-	-	9% (18% when the fixed amount of dividends is paid)	-	3% (VAT included)	

Source: own elaboration.

So the tax advantage of LLC is its flexibility. Depending on the form of payment (in cash or in kind) and the beneficiary of dividends: individual or legal entity, resident or non-resident, the amount of taxes and required

payments may increase or decrease significantly. Thus, depending on the taxation system and the beneficiary of dividends, the budget will receive from 12% to 54% of taxes and payments from the LLC and its participants. The undeniable tax disadvantage for LLCs is the rather large amount of taxes and mandatory payments withheld from dividends.

The main factor in determining the dividend policy is to maximise the profits of the company's owners. In practice, it has been found that most companies first define the amount of dividends as assets, and the balance is retained earnings. That is, if possible, the firm should withhold a return on investment, which in turn increases profits than the value of retained earnings. If the investment is not provided, the company must pay profits as dividends. This means that the company must treat retained earnings as assets, and dividends as passive residuals (Dhaval, n. d.). At the same time, there is an inverse relationship between the frequency of dividend payments and the company's profitability. The more often dividends are paid, the faster the company's profits will decrease (Docsity, n. d.).

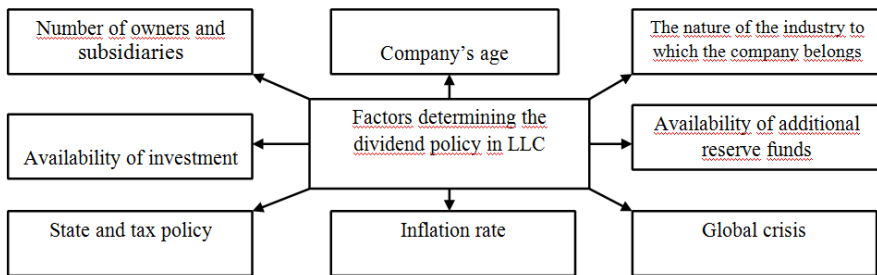
Taking into account the above, we can make a list of general important factors that may affect the dividend policy in the company showing them schematically in Figure 2. They include:

- a) Number of owners and subsidiaries. Companies with a large number of owners and subsidiaries will find it difficult to reach a common agreement on maintaining a conservative dividend policy. On the other hand, a company with a small number of owners and subsidiaries is more likely to have a well-established dividend policy.
- b) The company's age. The younger the LLC, the smaller the size of the reserve fund, the smaller the amount of dividends they can allow to pay. Besides, the older the company, the higher the corporate culture of dividend payment.
- c) The nature of the industry to which the company belongs. The business sector, where earnings are stable, is likely to provide greater dividends, the rate of return will be higher.
- d) Availability of investments. Companies with the prospect of profitable investments will seek to increase their profits and the frequency of their dividends. A study of 179 companies found that 64% of debt investors (unlike other groups of investors) in the company expand their business.
- e) Availability of additional reserve funds. In the event of a financial crisis or unforeseen costs, cash reserves support the business at a sufficient level.
- f) State and tax policy. Adopted or revoked interstate agreements to prevent double taxation of companies, loss of business partners due

to military conflicts (for example, due to the war in eastern Ukraine), as well as the level of taxes and fees set by the state significantly affect the success of society.

- g) Inflation rate. The inflation rate is inversely dependent on the number of dividends paid: the higher the inflation rate, the less dividends should be expected.
- h) The global crisis. For example, due to the Covid-19 pandemic, the world is experiencing a non-business crisis, but it is significantly affecting the efficiency of business operations. Because of the pandemic, governments around the world have imposed restrictions on business (domestic and interstate) and on society. Coronavirus has caused the reduction of dividends worldwide. A group of researchers found that depending on the type of industry, the crisis affects business profitability in different ways. There is no direct dependence of the pandemic impact on the company.

Figure 2. Factors determining the dividend policy in LLC (author's development)



Source: own elaboration.

The negative relationship between profitability, scope of influence and the size of the company in terms of dividend payments proves the theory of irrelevance of dividends as a business goal. The results show that investors are more concerned about the future performance of companies than current profits (Yasin *et al.*, 2017).

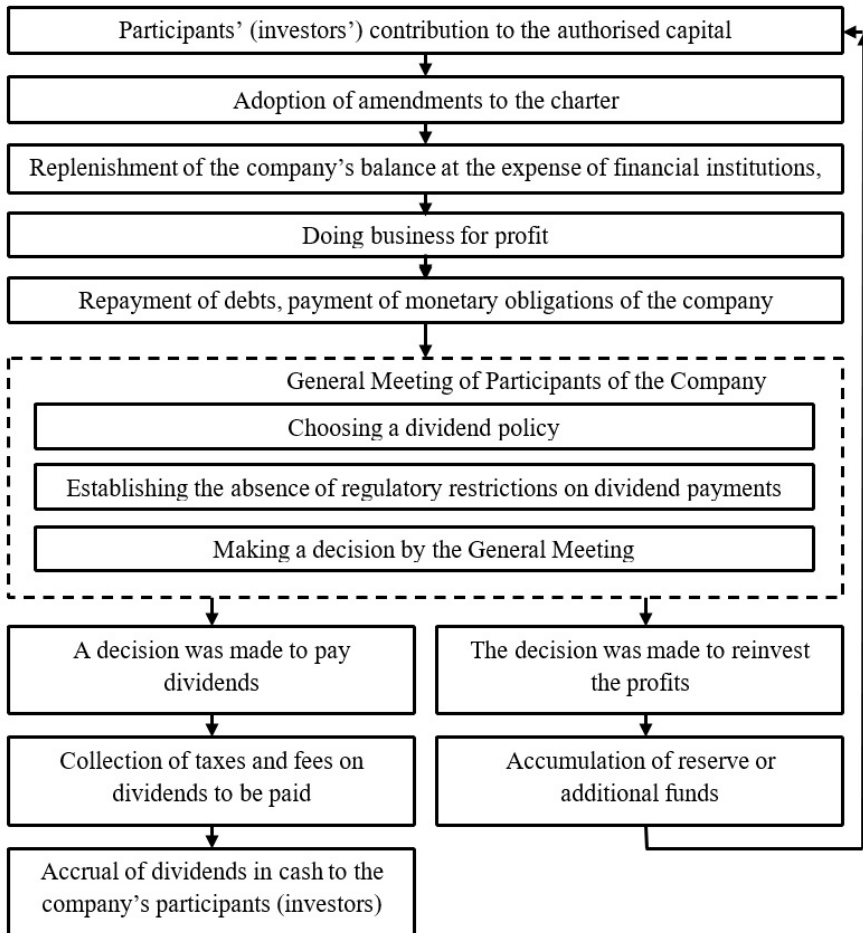
So, summarising the above, we present the general procedure and sequence of actions preceding the payment of dividends in LLC (Figure 3).

However, despite sufficient legal certainty, given the restrictions (including the chosen dividend policy in the company), which may affect the dividend payment procedure, some officials of the company may resort to risky and dishonest actions. Sometimes, resorting to a fictitious calculation, they set inflated profits or balance in order to make illegal dividend payments to the company participants. The Law on LLCs establishes only joint and several liability for obligations to return payments to LLC, if the company's participants were misled about its financial condition, in particular by presenting inaccurate information in the documents of LLC, which led to illegal payments. At the same time, other types of legal liability for "manipulation" of the company's balance, which leads to the payment of fictitious dividends are not provided. Korotash (2016) also rightly proposes to prohibit the adoption of decisions on the payment of dividends in LLCs that have not fully formed the authorised capital.

In the course of the research, the national system of tax and dividend payments in LLCs is schematically generalised. The peculiarity of this generalisation, in contrast to that given by Pomulieva and Remenyuk (2017), is the ease of use and conciseness of tax interest, as well as additional features of the general and simplified tax system.

The regulatory restrictions for payment of dividends in LLC are identified on the basis of generalisations of the current legislation and positions of scholars. In this case, the general list of restrictions is divided into two groups: internal and external, those that are directly regulated by internal economic activity and those that appear at the initiative of third parties, respectively.

Figure 3. The general procedure and sequence of actions preceding the payment of dividends in LLC (author's development)



Source: own elaboration.

4. Discussion

It is confirmed that the right to receive dividends from the participants of the LLC arises only upon the decision of the General Meeting on for such

payment. In case of the failure to pay dividends in a timely manner, they can be collected in court, referring to the LLC participants' liability for monetary obligations. Similar legal positions of the Supreme Court set out in the Supreme Court Rulings dated 30.10.2019 in Case No. 906/904/16, dated 16.06.2020 in Case No. 910/21232/16, dated 18.10.2018 in Case No. 923/1297/14, dated 14.07.2020 in Case No. 904/6379/16, dated 03.06.2020 in Case No. 4/44-B (Supreme Court of Ukraine, 2020). In these cases, the issue of imposing subsidiary liability for the LLC's obligations on the founders (participants) or other persons, including the head of the debtor.

In contrast to the proposed coverage of the peculiarities of the company's dividend policy and the assessment of its effectiveness by groups of scholars Derevinska and Ischenko (2016), a list of common important factors influencing the company's dividend policy was established. This takes into account the position of a group of scholars, namely: Rohov *et al.* (2020), that the financial indicators of dividend policy accurately classify only those firms that do not pay dividends. Therefore, these reasons are given without taking into account the qualitative and quantitative financial indicators.

An optimal dividend policy means that there must be an appropriate balance between the payment of current dividends and the future growth of the company's profits (Simple I Learn, 2016). Dividend payment is not the main goal of the business. To achieve success in business, the following dividend policy will be effective: the optimal compromise between the frequency and size of dividend payments on the one hand, and the investment of profits in the company's development on the other hand.

5. Recommendations

For investors:

Investors and potential investors are recommended to pay attention to the company's size, profitability and other important factors that determine the company's dividend policy. They can also help investors make decisions when acquiring a stake in the company's authorised capital and choosing a financial case based on the company's dividend policy.

For public authorities:

The results of this study can be used by financial managers and government policy makers to make appropriate decisions to increase guarantees and ensure regular dividend payment in LLCs.

Besides, at the legislative level, it is recommended to strengthen the liability of LLC's participants for the distribution of fictitious dividends and to prohibit unjustified and irrational distribution of profits in the form of

dividends on the basis of a decision of the General Meeting.

In a time when the global crisis has affected many modern forms of doing business in almost all sectors of the economy, there is a need for a unique partnership between government and business, especially in the regulatory system of dividend taxation.

For academicians:

It is expected that the limitations of this study will be detailed in further empirical work, especially on the impact of regulatory constraints on the regularity and amount of dividends paid in LLCs.

For lawyers:

It is recommended to lawyers in the recovery of arrears of previously unpaid dividends to use the developed general procedure and sequence of actions which precedes the payment of dividends in LLCs.

Conclusions

Thus, the legal regulation of LLCs in terms of dividend payments is quite flexible. Payment of dividends is not the main goal of business, because the company's success depends on the regularity of profits and the amount of capital of the company, and inversely depends on the regularity and size of dividends.

The results of this study confirm the hypothesis that the dividend payment policy in LLC has a significant impact on the company's value and the amount of capital. The analysis of the content of the documents allowed identifying eight important factors that influence the dividend policy in LLCs. Moreover, depending on the selected dividend policy, the payment of dividends will have a positive or negative impact on the amount of profit.

The study and arrangement of regulatory restrictions that determine the frequency and amount of dividend payment, as well as external and internal factors that determine the dividend policy in LLCs confirmed the second hypothesis. In particular, the tax policy of dividends significantly affects the frequency and the company's participants' willingness to receive dividends.

However, this study refutes the third hypothesis that the dividend payment in LLCs is determined solely by legal provisions, while other, informal factors affecting the frequency and amount of dividend payments, do not exist. Despite the fact that the dividend payment procedure is formally defined and enshrined in law, the decision of the General Meeting and the Company's dividend policy are the determining factors for dividend

payment. Many researchers have tried to cover the problems of choosing the optimal dividend policy, but still there is no decent explanation of the reasons for choosing a certain dividend policy in the company. However, it can be stated unequivocally that the type and form of dividend policy in LLCs is partly regulated by law, and partly determined by business, non-legal factors. The above general procedure and sequence of actions preceding dividend payment in the company indicates the partial entrepreneurial freedom of the company's participants in this matter.

It was found that depending on the tax system and beneficiary of the dividends, the budget will eventually receive a significant amount from 12% to 54% of taxes and fees. However, despite its flexibility, Ukraine is in the world rankings of countries in terms of business support. Therefore, in modern conditions, the system of current taxes and fees needs to be tempered in terms of dividend payments in LLCs.

The issue of liability for the distribution of fictitious (non-existent) dividends in LLCs remains unresolved. Although the participants are jointly and severally liable only for the obligation to return the company's payments for misleading the company's members regarding its financial condition, I propose to prohibit unjustified and irrational distribution of profits in the form of dividends based on the decision of the General Meeting. Besides, in order to increase the efficiency of regulation of dividend payment, depending on the consequences of the failure to pay, I propose to introduce criminal liability for such actions. Under such changes, LLC officials will be more careful when deciding on the payment of fictitious dividends.

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CUESTIONES POLÍTICAS

Vol.39 N° Especial

*Esta revista fue editada en formato digital y publicada en octubre de 2021, por el **Fondo Editorial Serbiluz**, Universidad del Zulia. Maracaibo-Venezuela*

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