CAN UNLAWFUL DIVIDENDS RECEIVED BY COMPANY DIRECTOR/SHAREHOLDERS BE LATER RECLASSIFIED AS REMUNERATION TO AVOID LIABILITY?

THE RECENT CASE OF *RE BRONIA BUCHANAN ASSOCIATES LIMITED* [2021] EWHC 2740 CONFIRMS THAT THERE CAN BE NO SUCH RETROSPECTIVE RE-CHARACTERISATION.

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In small private companies, director shareholders often draw sums from the company periodically throughout the year adopting a particular arrangement calculated to provide tax benefits. A relatively small amount of salary (generally below the threshold for income tax and National Insurance) is paid through PAYE, and, at year end, a dividend is declared, to be set-off against the indebtedness of the director arising by way of the balance of their drawings. In this way, directors benefit from the lower tax rate payable in respect of dividends as compared to salary paid via PAYE.

The courts have considered on numerous occasions whether, in the event the company's distributable reserves at year end are insufficient to declare a dividend equivalent to the director's indebtedness, the drawings can be re-characterised as salary, with the result that the director's indebtedness to the company is wiped out. These decisions have generally arisen in the context of claims issued after the company has entered liquidation by which the liquidator seeks repayment of the director's debt.

In the recent case of Bronia Buchanan, Insolvency and Companies Court Judge Burton held definitively that directors could not rewrite history, and that drawings cannot be re-characterised as salary after the event.

The facts of the case were that liquidators issued a claim against a company director seeking repayment of c.£286,000, on the basis that the director had received these sums from the company not as salary or dividends (the company having made insufficient profits to declare dividends in this amount), but as a loan, which was unpaid. The respondent director argued that, whilst she was officially paid an annual salary of £6,000 through PAYE, this was not commensurate with the services she provided to the company, often working 15 hours a day, and that all the sums she received were intended to be, and should be treated as, remuneration.

ICCJ Burton first referred to the principle that, where a director is proved to have received payments from the company, the evidential burden shifts to the director to demonstrate that they received such payments lawfully: *Re Idessa (UK) Limited* [2011] EWHC 804.

The Judge went on to find that the only way in which a director/shareholder may lawfully take out money from a company (other than being reimbursed expenditure incurred on the company's behalf) is by way of salary or dividends.

The respondent director had chosen to fix her remuneration at £6,000 to take account of PAYE and National Insurance thresholds, and at all times the respondent intended or hoped that the company would ultimately make enough profit to declare dividends which would cancel out the sums due by her to the company. Further, the company's articles provided that the company's

directors were entitled to remuneration as fixed by ordinary resolution of the shareholders, and there had been no ordinary resolution declaring the outstanding sums to be salary during the year. Unless the company resolved to increase the director's remuneration from £6,000 per annum, to the extent the director withdrew greater sums from the company, those amounts would be treated as a loan from the company to her.

ICCJ Burton observed that, if a retrospective accounting adjustment were possible, most director/shareholders would adopt such practice They would approve payment to themselves of a small salary, and take more than that amount out of the company throughout the year, in the hope of receiving sufficient dividends at year end to repay their debt. If the company made a loss, or entered liquidation, the director would change the accounts to award themselves what they thought was a fair remuneration, to the detriment of creditors.

The decision takes a stricter line to that taken in previous cases.

In *Re Jones* [2020] EWHC 1112 Mr Justice Snowden held that drawings could not be re-characterised as remuneration whenever it suited the director, but qualified this by suggesting that a re-characterisation could possibly take place if the director acknowledged that the manner in which the drawings had been disclosed to HMRC had been incorrect, with all the consequences in terms of the payment of additional tax, interest and penalties that this might entail.

In *Re Global Corporate Ltd v Hale* [2018] EWCA Civ 2618 Patten LJ suggested that, where unlawful dividends had been paid during the year, the monies could possibly be notionally repaid and then re-applied in a way which was a lawful application of the company's assets, although this formal step would need to be taken prior to the company entering liquidation.

In *Bronia Buchanan* the respondent argued that her drawings could be retrospectively re-characterised and that she would make appropriate retrospective declarations to HMRC, the arrangement referred to in Re Jones. ICCJ Burton rejected this argument, stating categorically that no such re-characterisation could occur.

She said that 'it is simply not open to a director to recreate history and the basis upon which they have historically received money from a company'.

It is well established that a director cannot overcome this position by seeking to set-off a liability to repay drawings by way a quantum meruit claim for services rendered. Unless a director's remuneration is agreed in accordance with the procedure referred to in the articles, directors have no entitlement to remuneration for work done for the company, and so cannot bring a quantum meruit claim: *Guinness plc v Saunders* [1990] BCLC 402. Further, even if a director could bring a quantum meruit claim, this claim faces the difficulty of being an unliquidated claim, which will need to be proved in the liquidation: *Global Corporate*.