# Can you Backdate your salary?

Elliot Green highlights a case involving an Overdrawn Directors Loan Account that every director should commit to memory.

The case of Bass v Buchanan [2021] EWHC 2740 (Ch) highlights the reason that you cannot backdate your salary, and is an important decision handed down by Insolvency and Companies Court Judge Burton.

This was a case in which the company, Bronia Buchanan Associates Limited, went into Creditors Voluntary Liquidation on 2 December 2014.

The Liquidators brought legal proceedings against Bronia Buchanan in respect of what was, in a nutshell, an Overdrawn Directors Loan Account.

An Overdrawn Directors Loan Account might be considered one of the more straightforward legal claims that a Liquidator might bring in a Liquidation.

This case demonstrates, however, that whilst the Liquidators were undoubtedly victorious, there is nevertheless a risk with any piece of insolvency litigation. One of the reasons there is always a risk is perhaps that the Liquidator enters office as stranger to the company's affairs. He or she has to piece the jigsaw puzzle together and assess what really happened, dealing with any conflicting stories that might sprout.
The part of the Liquidator's Application brought against Bronia Buchanan that really put the cat among the pigeons was the following: "A declaration that the reclassification of the sums outstanding on the director's current account on 10 September 2014 as 'drawings' was ineffective to release Ms Buchanan's liability to the Company."

The Court found, as with many Overdrawn Director Loan Accounts, that what was going on was money being drawn in anticipation of future dividends being available to clear the problem.

However, as the pressure on the company grew from HMRC tax debts, it seems that what became known as the 'Reclassification' developed. This was the proposition that the Overdrawn Loan Account position was adjusted and then deemed to be 'drawings'.

The problem, however, is that seems to suggest that if you were permitted to do this you would be able to adjust historic accounting events. The Court broadcast an important rationalisation: "In so far as the defence relies on the payments received by Ms Buchanan from the Company being 'drawings', it recognises the need to make retrospective declarations to the Revenue. This is precisely the type of arrangement described by Snowden J in The Sky Wheels Group of Companies. At paragraph 50 of his judgment (set out at paragraph 35 above) he said that such drawings cannot simply be re- characterised as remuneration when it suits the recipient so to contend. He qualified this by saying that they could not do so, 'at least' without paying the

additional tax, interest and penalties that this would entail. He did not have to expand on this ‘at least’ provision further.

When he put to the director/ shareholders’ counsel whether being remunerated in that way was consistent with the manner in which the regular payments had been presented to HMRC, the argument was withdrawn. “In my judgment, it is simply not open to a director to recreate history and the basis upon which they have historically received money from a company.

Following Re Idessa, having established by reference to the Company’s accounts that significantly more was paid to Ms Buchanan than was expressly accounted for as salary or dividend, the burden of proof lies with Ms Buchanan to show that she was entitled to receive those monies.

“The last-minute attempt to reclassify the payments as ‘drawings’ could not alter the basis upon which they had been paid and received throughout the Company’s prior trading periods. I have little doubt that if such a retrospective accounting adjustment were possible, most companies’ owner-directors would adopt a similar practice. They would approve payment to themselves of a salary below the income tax threshold and then take more than that amount out of the company on a monthly basis in the hope of earning sufficient dividends by the end of the year to repay any debt due from them to the company. If it then transpires that the company makes a loss, or worse, enter liquidation, they would change the accounts to show that whilst creditors may not be paid in full, they should nevertheless receive what they consider to be a fair amount to compensate themselves for the hours they spent working for their own company, even though it has not been sufficiently successful to pay all of its Debts.”

## The Ivy meeting

Barry Lewis was previously one of the Liquidators. It was contended by the Respondent’s husband, Mr Drew, that he and Mr Lewis had met at the Ivy Club in Covent Garden to consider various matters:

Mr Drew sought the professional advice of Mr Lewis with whom he had worked previously. On 20 August 2014, he sent a formal memo instructing Harris Lipman, stating inter alia: ““The balance sheet shows a directors loan has been in existence since 2007 and currently has a balance of £201,562.”

It appears that Mr Drew and Mr Lewis had different recollections of that meeting. Mr Drew said at the meeting Mr Lewis had told him: “On the question of the directors loan/drawings Mr Lewis’s advice was to identify these as drawings rather than loans as it appeared that was what they were, given the minimal salary the Company had paid the Respondent.

It was recognised this would raise separate issues with the Inland Revenue and which would have to be dealt with separately when the matter arose.”

Mr Lewis contested this version of events.

The Court found Mr Lewis to be a credible witness: “I would have told Mr Drew at our meeting on 4 September 2014 that the Overdrawn Director’s Loan Account was a big issue as it would need to be recorded on the company’s statement of affairs as an asset of the company and it would have to be repaid by the Respondent. This is why I said to him in my email of 21 August 2014 that a further discussion would be required in relation to the Director’s Loan Account. However again, I seriously underline that I would not have recommended to Mr Drew that an Overdrawn Director’s Loan Account be converted to or identified as ‘drawings’ because it is highly irregular, illegal and in breach of the relevant tax legislation, so a non-starter as far as I am concerned. As an aside, even if I had given the advice that Mr Drew alleges I did, which I categorically reaffirm I did not, the entries that were made on the company’s QuickBooks ledgers do not in any event
achieve the purpose of converting or re-classifying the Overdrawn Director’s Loan Account to ‘drawings’.”

In effect, Mr Lewis, in dealing with the question of whether you can backdate your salary – no, you cannot.

## Mr Drew

The Court had this to say about Mr Drew: “Mr Drew appeared to me to be very guarded in his evidence to the point that I consider his answers to some of counsel’s questions were less than candid. He is a solicitor, with experience appearing on behalf of clients in the bankruptcy and winding-up courts. As such, whether as part of his training or from experience in practice, it is more likely than not that he would have a basic understanding of company accounts.

When asked whether he agreed that the Company’s 2011/12 accounts were prepared on the basis that sums due from Ms Buchanan were an asset of the Company, he replied that he could not agree as he does not have a detailed knowledge of the Company’s accounts going back through the years. This is despite: (a) the accounts, included in the bundle of documents, clearly recording for the year 2011/12 a debt due from Ms Buchanan of £83,781; and (b) his letter of instruction to Mr Lewis dated 20 August 2014 expressly stating that the balance sheet shows a director loan has been in existence since 2007 and “currently has a balance of £201,562.”

Similarly, when counsel asked him to confirm that Ms Buchanan never paid anything to HMRC in respect of the sums now claimed to have been ‘drawings’, he said that he could not say, as he did not know about her personal tax affairs at the time. Whilst he may not have known the full details of her personal tax affairs, his witness statement stated in relation to the proposed Reclassification that “this would raise separate issues with the Inland Revenue and which would have to be dealt with separately when the matter arose”. This suggests to me that contrary to his evidence, he was aware that Ms Buchanan had not declared the sums she received from the Company as income, for tax purposes.

Mr Drew said that he was never clear that the DCA was genuinely a loan account. The true position was, to his mind, unidentifiable as "the paperwork wasn't there". He said that the money was paid to Ms Buchanan as compensation for her role as principal of the business: that was where the drawings came from. It was treated as money paid to her "as compensation for her time and effort".

Mr Drew was adamant that Mr Lewis had advised him to arrange for the loan account to be reclassified as drawings.

This strikes me as inconsistent with his replies during the interview on 9 July 2015 when, even though he was being interviewed by one of Mr Lewis's colleagues, he made no mention of Mr Lewis's advice and described the loan account as having been a historical problem which was reclassified "cos, physically it couldn't be repaid". He said that if, prior to liquidation, Mr Lewis had advised that the money would have to be repaid, he would not have put the Company into liquidation. He would have tried to have agreed a time-to-pay arrangement with HMRC in order that the Company could continue trading. In light of the Revenue's petition, and Ms Buchanan's apparent inability to repay the loan, the Company's options, at that stage, appear to me to have been limited.

## Bronia Buchanan

Bronia Buchanan ran the business at the relevant time and as with many directors considered that she was deserving of money from the company. It seems that the problem for Ms Buchanan was that the monies she had received leading to a massive Overdrawn Directors Loan Account of around £200,000, resulted in the absence of procedures being deployed to enable her to draw such monies from the company as salary.

Further, there were insufficient profits to hoover the same up as a dividend: "The crux of Ms Buchanan's defence is that the amounts she received from the Company should at all times have been recorded as salary. She was officially paid an annual salary of £6,000 but that was not commensurate with a director who often worked 15 hours a day for a business with an approximate annual turnover of £500,000, eight employees and, at one time, more than 400 clients.

The payments were never, as suggested by the liquidators, intended to be on account of future dividends; Ms Buchanan was not waiting for the end of the financial year before a reconciliation exercise could be undertaken. At all times, she was entitled to the money as 'drawings' and entitled to retain them.

"Ms Buchanan concedes that she ought to be criticised for not declaring the payments to HMRC as income. She seeks to excuse her failure to do so, by saying that at all material times she relied on the advice of professional advisers who assured her that "financially matters were fine" and that if Mr Cunningham had advised her: '...at any time to declare my drawings in another manner I would have done so'.

“Ms Buchanan struck me as an intelligent woman. She no doubt appreciates the severe financial liabilities that could land at her door if the Applicants’ claim against her succeeds. The Applicants have not challenged her statement that she worked very hard for the Company.

When counsel suggested that she was not entitled to receive more than £6,000 per annum by way of salary, she appeared to be affronted, saying that “of course” she was entitled to receive more than that – otherwise she could not possibly afford to pay her mortgage. This, to me, lies at the heart of Ms Buchanan’s defence and evidence: having expended significant efforts running a £500,000 turnover business, she felt she was entitled to be paid for her services.

She would rather blame her own negligence and incompetence in failing to manage, or even seek to understand the Company’s financial affairs, and for failing to challenge Mr Cunningham or insist that he explain what she was being asked to sign and, when giving evidence, to make serious allegations about his business practices, than risk saying anything which might suggest that she might have to pay the money back. I treat her evidence with corresponding Caution.”

## Relevant legal principles

The relevant legal principles about Directors taking monies from their companies were neatly summarised by the Court as follows: “...the relevant binding principles succinctly summarised by District Judge Kelly in his approved ex tempore judgment in Henderson & Jones Limited v Garry Patrick Price [2020] EWHC 3276 (Ch):

“**13.** The claimant brings this case and has to prove the claim on the balance of probabilities. However, there is a shift of evidential burden if the claimant can establish that the relevant payments were made to the defendant in his capacity as a director.

“**14.** The claimant relies upon the case of Re Idessa (UK) Limited [2011] EWHC 804, where Lesley Anderson QC addressed the burden of proof as follows: “I am satisfied that, whether it is to be viewed strictly as a shifting of the evidential burden or simply an exchange of the well-settled principle that a fiduciary is obliged to account for his dealings with the trust estate, that Mr Aslett is correct to say that, once the liquidator proves the relevant payment has been made, the evidential burden is on the respondents to explain the transactions in question.

Depending upon the other evidence, it may be that the absence of a satisfactory explanation drives the court to conclude that there was no proper justification for the payment. However, it seems to me to be a step too far for Mr Aslett to say that, absent such an explanation, in all cases, the default position is liability for the respondent directors. In some cases, despite the absence of an adequate explanation, it may be clear from other evidence that the payment was one which was made in good faith and for proper company purposes.”

**15.** The case of Re Mumtaz Properties Limited [2011] EWCA Civ 610 considers the status of a ledger in the context of a case of this nature. In that case the company had been using an

electronic Sage ledger described as a director's loan account. Arden LJ, at paragraph 17, stated as follows: "...it was not open to the respondents to the proceedings in the circumstances of this case to escape liability by asserting that, if the books and papers or other evidence had been available, they would have shown that they were not liable in the amount claimed by the liquidator. Moreover, persons who have conducted the affairs of limited companies with a high degree of informality, as in this case, cannot seek to avoid liability or to be judged by some lower standard than that which applies to other directors simply because the necessary documentation is not available..."

**16.** Arden LJ continued at paragraph 57: "In my judgment, he (the judge) was entitled to find, in the absence of evidence as to how and why the entry had been made, that it was what it appeared to be, namely a debit entry duly made and increasing Munir's liability on his director's loan account. Munir produced no evidence showing how the entry had come about and provided no explanation for the absence of such evidence. The judge was entitled to infer that he could have made enquiries about this entry if there was any evidence or explanation that would support his case."

**17.** The case of GHLM Trading v Maroo [2012] EWHC 61 , considered by Newey J (as he then was), agreed with the proposition that the evidential burden shifted to the director to justify entitlement to sums of money appearing on the director's loan account. He said as follows: "...once it is shown that a company director has received company money, it is for him to show that the payment was proper. In a similar way, it seems to me that, where debit entries have correctly been made to a director's loan account, it must be incumbent on the director to justify credit entries on the account."

**18.** The theme is continued in Toone & Murphy v Robbins [2018] EWHC 569 where Norris J said: "...the mere fact that some lawful payment could be made and that this particular payment was made does not mean that this particular payment was lawful."
The case is of further relevance to the facts of the matter before me today in so far as Norris J went on to hold, at paragraph 40, that section 1157 of the Companies Act 2006 does not allow relief to be granted to a director to enable him to escape liability in respect of sums received by him.

**19.** The claimant further relies on Re The Sky Wheels Group of Companies Limited [2020] EWHC 1112, in which Snowden J, said as follows: "49 ...It is frequently the case in small private companies that persons who are both directors and shareholders are paid only a relatively modest amount of remuneration for their work through the PAYE system. They then enter into an informal agreement or arrangement between themselves to draw sums of money from the company periodically during the year. Those sums are then debited to the directors' loan accounts in the expectation that, at the end of the year, the company will be in a position to declare a dividend. The intention is that the resultant debt created by the declaration of dividend (of the company to the shareholders) will be set off against the indebtedness of the directors on their loan accounts. Under such an arrangement, the periodic drawings are not declared as

remuneration for the purposes of PAYE and NIC. Instead, the directors and shareholders benefit from the more favourable tax treatment accorded to dividend payments.
“50. In light of the manner in which such arrangements are presented to HMRC, in general terms, I do not consider that such periodic drawings can simply be re- characterised as remuneration as and when it might suit one of the recipients so to contend. Or at least that cannot be done without acknowledging that the manner in which they had previously 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.”

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