No turning back

Whether director drawings be changed from dividends to salary after the event is an often-debated issue. The short answer is no – and here Elliot Green explains the reasons why

This question was answered in the case of Jones v The Sky Wheels Group Ltd [2020] EWHC 1112 (Ch), and in general terms the answer is no they cannot.

Director drawings are monies drawn down from a company and paid over to the director personally. This is usually done to reward a director for their services to a company.

Christopher Jones was a director of The Sky Wheels Group Ltd ('the Company') and he fell out with the majority shareholder David Schofield, due to amongst other things the deployment of certain of the company's funds, according to the case report.

As a result, it was reported in the court's judgment provided by Mr Justice Snowden (now Lord Justice Snowden), that Schofield excluded Jones from the management of the company.

The case involved an application by Jones to set aside a Statutory Demand issued by the company and its subsequent appeal when it was set aside by Deputy District Judge Watkin.

The company issued a Statutory Demand on Jones for payment of an alleged overdrawn director's loan account in the sum of £418,609.28, later reduced to £340,745.57.

The company operated the clearing of the directors' loan accounts in a typical SME fashion by drawdown of monies during the period, then offset by way of an annual dividend and a minimal salary to minimise the tax consequences.

How the dividend operated

Consistent with many SMEs, it operated a monthly director drawing system whereby a sum of £8,250 was a payment in advance (advanced dividends) or on account of the expected annual dividend.

The Judge explained matters in this way: "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."

However, what is notable is that even though it is common practice for dividends to in effect act as part of arrangements for remuneration, they are all too often not recorded as remuneration, they are not declared as remuneration and they are not taxed as remuneration. The effect of this means that such payments cannot be then after the event at a later date be treated as remuneration.

What determines the nature of a director's drawings?

Once money has been taken by way of a movement of funds from a company's bank account to the director's personal account the transaction has completed. The effect of that leaves recording and declaration to be addressed. The transactions of a company may be recorded at a later date and not necessarily on the day, week or in some cases even month when it occurs. As a result, the nature of such transactions might be recorded in a company's books and accounting records long after they happened.

However, accounting software (such as that offered by Xero, FreeAgent and other accounting software providers) has moved on considerably in recent years and they can now predict with reasonable accuracy from bank movements the nature of transactions. However, the key determining feature of what a transaction of this nature is when there is uncertainty is how it has been recorded in the published statutory accounts at Companies House and represented to HMRC in a corporation tax return.

That position was articulated by the Judge as follows: "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."

In effect, the Judge was saying you cannot backdate your salary if it suits you, later on, to do so.

Jones was, therefore, unable to say that the director drawings he had received were remuneration.

The problem Jones faced notwithstanding that the Statutory Demand levied against him remained set aside, was that the anticipated dividend did not happen. As a result there was £144,868.08 that had been debited to his loan account with the company that was said to remain owing:

The Judge said: "…I conclude that the £144,868.08 debited to Mr. Jones' loan account represents an amount owing from him to the company. For the same reason, the cross-claim of £74,250 made by Mr. Jones against the company for 'unpaid salary' from July 2018 to March 2019 (i.e. nine months at £8,250 per month) must fail."

Comment

It is common practice in the case of SMEs to sort out director's drawings when the annual accounts are prepared often by declaring a dividend to clear an overdrawn director's loan account.

However, when a substantial element of a director's drawings is dealt with in this fashion the director can be in for a rude awakening as a whole year's drawings might have to be repaid.

The Sky Wheels Group case shows how things can go wrong when directors fall out and a shareholder dispute sprouts. The same may often arise if a company is insolvent and it cannot lawfully declare a dividend.

So in relation to company transactions: determine their nature, record them and then declare them, in that order.

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