TC04171

Appeal number: TC/2013/00627 & TC/2013/00630

INCOME TAX – PAYE and national insurance contributions – payments of interim dividends – effect of reclassification prior to liquidation of company – whether wilful failure to operate PAYE and pay national insurance – whether directors liable for tax and national insurance because they knew of wilful failure – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

RICHARD JONES **Appellants**
JULIE JONES

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE JONATHAN CANNAN
MISS SUSAN STOTT FCA

Sitting in public in Manchester on 21 August 2014

Mr Peter Davies ATT of WMT Chartered Accountants for the Appellants

Mr Michael Boyle of HM Revenue & Customs for the Respondents

DECISION

1. The appellants, Mr and Mrs Jones, were both directors of Perfect Change Limited ("the Company") which carried on business as a recruitment consultancy. They owned 65% and 35% respectively of the share capital of the Company.

2. The Company commenced trading in July 2003 and went into insolvent liquidation in February 2009. Following the insolvency HMRC investigated whether there had been a wilful failure to deduct tax and national insurance from Mr and Mrs Jones' emoluments in 2007-08 and 2008-09. The investigating officer, Mrs Elizabeth Taylor, concluded that there had been a wilful failure to deduct tax and pay national insurance and that Mr and Mrs Jones knew of that failure. As a result HMRC utilised its powers, described in more detail below, to recover the tax and national insurance from Mr and Mrs Jones.

3. The issues on this appeal concern whether HMRC are entitled to recover the tax and national insurance from Mr and Mrs Jones. In broad terms the principal issue is whether Mr and Mrs Jones received emoluments knowing that the Company had wilfully failed to deduct PAYE and pay national insurance. Mr and Mrs Jones say that payments to them by the Company were dividends rather than emoluments and that there was no obligation to operate PAYE and national insurance.

4. We are not concerned with any issues in relation to quantum. The appellants accept that if HMRC is entitled to recover the tax and national insurance then their liability is for the sums as claimed.

5. We shall deal firstly with our findings of fact based on the evidence before us. We heard oral evidence from Mr Richard Jones on behalf of himself and his wife. We also had witness statements from Mr Jones' father, Mr Brian Jones and from Mrs Jones' uncle, Mr John Smith. Mr Boyle on behalf of HMRC did not challenge the evidence contained in these witness statements and we accept the evidence of Brian Jones and John Smith.

Findings of Fact

6. Mr Jones had 5 years experience working in recruitment prior to the Company commencing business. Mrs Jones had run her own consultancy business for 3 years. The Company's business was primarily recruitment in the banking and financial services sector.

7. When the Company commenced in business its accountants at that time advised Mr and Mrs Jones that the most tax efficient way to receive income was by way of interim and final dividends, combined with modest monthly payments of directors fees. That is common advice to small business and it was followed by Mr and Mrs Jones. The Company was immediately profitable and able to lawfully pay dividends.

8. In 2007 the Company changed its accountants to Clark Nicklin. Mr and Mrs Jones continued to receive directors' fees and interim dividends, paid on a monthly

basis. The directors fees were £450 per month so that very little or no PAYE or national insurance contributions were payable.

9. Clark Nicklin operated the company's payroll and directors fees were entered into the accounts as directors' remuneration. The Company used Sage accounting software which produced monthly management accounts. Clark Nicklin visited every month to make any necessary adjustments and to ensure the Sage accounting system was operated correctly. They also prepared all tax returns and computations for the Company and for Mr and Mrs Jones' personal tax affairs.

10. The annual accounts for year ended 31 March 2007 showed directors' salaries of £10,800 and dividends of £139,000. The first set of draft accounts for year ended 31 March 2008 which had been produced by 9 May 2008 showed directors' salaries of £10,800 and an interim dividend of £138,100.

11. The wages account was updated on a monthly basis and showed Mr and Mrs Jones receiving wages of £450 per month. There were 3 or 4 other employees and PAYE and national insurance were deducted and paid from their wages.

12. The management accounts included a profit and loss account, aged debtor and creditor listings, cashflow forecast and balance sheet. They were produced on a monthly basis.

13. We are satisfied that on a monthly basis Mr and Mrs Jones considered the management accounts, and the current and future work levels in order to set the level of interim dividends. The interim dividends were posted to a dividend ledger each month by Mr Jones. That ledger was part of the Sage system which was checked and reconciled by Clark Nicklin on their monthly visits. Clark Nicklin were clearly aware that Mr and Mrs Jones were receiving interim dividends. It was not clear to us whether the dividends were paid in cash or credited to Mr and Mrs Jones' directors' loan account. In any event there was no suggestion that Clark Nicklin ever advised prior to January 2009 that interim dividends were unlawful.

14. Mrs Jones as Company Secretary produced interim dividend vouchers on a monthly basis. We were provided with some examples, including a dividend for the year ended 31 March 2009 payable on 1 September 2008 at the rate of £15,000 per share to Mr Jones. We were provided with a copy of the dividend ledger for the period April 2007 to January 2009. Mr Boyle did not challenge that the payments made during this period were intended to be dividends.

15. We were also provided with copies of the monthly profit and loss accounts for the periods ending 31 May, 30 June, 30 November and 31 December 2008. These had been printed off 2 days before the hearing but they included certain anomalies. For example the monthly figures did not appear to reconcile to the year to date figures. It seems unlikely that the documents we saw were in the form available to Mr and Mrs Jones in 2008. The explanation for that is not clear, but the anomalies may have been caused by subsequent adjustments made by Clark Nicklin.

16. The Company factored its debtors with a company called City Invoice Finance Limited ("City Invoice"), part of Cattles Plc. 90% of invoice amounts payable were factored. As part of the factoring agreement the Company had to send management accounts to City Invoice on a monthly basis.

17. By the summer of 2008 the Company began to start feeling the effects of the global financial crisis. Thereafter some contracts which were coming to an end were not renewed or if they were renewed then it was on less favourable terms. Mr and Mrs Jones took steps to reduce costs and overheads. In late August 2008 they sought advice from Mr John Smith who is Mrs Jones' uncle in relation to the reduction of costs and maintaining profitability.

18. John Smith had worldwide experience in managing and developing small and medium sized enterprises for sale, and in improving the profitability and performance of under-performing businesses. In the latter part of 2008 he was carrying out a detailed review of the Company's financial position. His view was that the prospects for the business were good although the cost structure of the business needed to be adjusted.

19. In the latter half of 2008 Mr and Mrs Jones reduced the level of dividends by 50%. In the period 26 August 2008 to 22 December 2008 they received dividends of £22,000. In the same period in 2007 they had received dividends of £56,950.

20. Mr and Mrs Jones were satisfied throughout 2008 that the profitability of the Company justified the continued payment of interim dividends. Indeed they thought that December 2008 had been their best month ever so that in January 2009 they considered that the Company had good prospects for the future.

21. There was documentary evidence before us which indicated that in January 2009 City Invoice alleged a breach by the Company of the factoring agreement. On 22 January 2009 City Invoice emailed Mr Jones referring to a discussion they had had in which Mr Jones was said to have acknowledged a material breach of the factoring agreement in failing to assign credit notes in a timely manner. Mr Jones said in evidence that he had been 3 days late over the Christmas period in processing a credit note. We have no reason to doubt his evidence.

22. On 23 January 2009 Mr and Mrs Jones attended a meeting with the managing director of City Invoice. Brian Jones attended at the request of Mr Jones. They were told at that meeting that City Invoice was withdrawing the Company's credit facility and the Company was immediately required to repay all outstanding sums due to City Invoice.

23. Brian Jones had 30 years experience in commercial banking prior to retiring, with 8 years as a main board director of Co-operative Bank. Prior to the meeting with City Invoice he had looked at the Company's accounts and considered that it was a going concern with a strengthening pipeline of work. At the meeting he gained the impression that City Invoice were seeking to reduce the overall size of their loan book and that was the real reason they had withdrawn the factoring facility.

24. Mr Jones immediately sought to obtain alternative funding for the Company but without success. On 26 January 2009 Brian Jones advised his son and daughter-in-law to seek professional advice. On the same day Mr and Mrs Jones together with John Smith attended a meeting with Mr Andrew Baggott of Clark Nicklin. Mr Baggott advised Mr and Mrs Jones to consult with an insolvency practitioner with a view to putting the Company into liquidation.

25. According to Mr Jones, Mr Baggott also advised at this meeting that there were overdrawn director's loan accounts and that the liquidator would seek repayment. Mr Jones understood that the overdrawn loan accounts had been caused by the payment of interim dividends. There was a suggestion that Mr Baggott considered there was a risk that the liquidator might treat them as unlawful dividends. We are not sure why the interim dividends would have been treated as directors' loans and we shall return to that point. In any event Mr Baggott advised Mr and Mrs Jones to treat the sums originally received by way of dividends as remuneration subject to PAYE and national insurance. We have adopted the parties' description of this as a "reclassification" although that term is not entirely apt. Mr and Mrs Jones followed the advice, but they did not fully understand the reasons for it or the implications of doing so.

26. It seems to us that Mr Baggott was focussed on the possibility of the liquidator reclaiming sums paid to Mr and Mrs Jones on the basis that they were unlawful dividends. It was not clear why he doubted the lawfulness of the dividends. This was an emotional time for Mr and Mrs Jones but we think they at least understood that reclassifying the payments as salary was intended to avoid a potential claim by the liquidator. Neither Mr Baggott nor Mr and Mrs Jones appreciated that HMRC might then seek to recover PAYE and national insurance on the payments from Mr and Mrs Jones personally.

27. John Smith's account of the meeting with Mr Baggott was that Mr Baggott described in detail what would happen in the insolvency process. Mr Baggott's advice was that the dividends should be treated as salary and as such would attract PAYE. John Smith counselled Mr and Mrs Jones to accept Mr Baggott's advice in this regard.

28. On 30 January 2009 notices convening the creditors' meeting were sent out. The period in late January 2009 to the creditors meeting on 20 February 2009 and beyond was clearly an emotional time for Mr Jones. He had built up the business together with his wife and it had failed. He felt that he had let down his family and friends. He acted on advice without fully considering or understanding that advice.

29. Mr Jones had half an hour before the creditors' meeting to review the statement of affairs, the draft accounts for the year ended 31 March 2008 and the report to creditors which had been produced by Clark Nicklin. He swore the affidavit containing that statement of affairs. He told us, and we accept, that Mr Baggott advised that if the question of dividends came up then he should say that payments made were salary.

30. Following the meeting on 26 January 2009 Clark Nicklin had done further work on the draft accounts for the year-ended 31 March 2008. These were presented to the creditors meeting which took place on 20 February 2009. The draft accounts showed dividends of £45,000 and directors' salaries and national insurance contributions of £213,178. The report to creditors notes the following:

> "*According to the director [Mr Jones] the Draft Management Accounts are slightly incorrect in that no dividends were paid to the Shareholders and this will need to be reviewed by the duly appointed Liquidators.*"

31. We find as a fact that Mr Jones made this statement on the advice of Mr Baggott but without fully understanding why there was a need to reclassify the dividends as salary or what the reclassification involved.

32. The draft accounts were unsigned and undated, although the intended date of the report of directors was in November 2008. We do not consider that this is reliable evidence that a decision to reclassify the interim dividends as salary had been taken by November 2008. There may well have been a draft earlier than February 2009. The decision to reclassify the dividends as salary was taken at the meeting on 26 January 2009.

33. There was no evidence as to why the draft accounts presented to the creditors' meeting showed dividend payments of £45,000. Mr Jones did not know why. Clark Nicklin subsequently told the liquidator that it was a mis-posting in the Sage records and that the sum ought to have been allocated as wages, increasing the PAYE and national insurance liability. The liquidator has subsequently stated in correspondence that he had no evidence to suggest that this explanation was incorrect. He did not seek to challenge any dividend or indeed salary payments.

34. The draft accounts showed overdrawn directors' loan accounts totalling £31,641 as at 31 March 2008.

35. The report to creditors for the meeting on 20 February 2009 records that turnover started to decline after August 2007 and the Company made a loss of £185,632 in the year-ended 31 March 2008. In 2008-09 turnover decreased further and the directors were unable to return the business to profitability. Difficulties in relation to certain overseas contracts and the absence of work in the pipeline led the directors to seek advice from their accountants at the end of January 2009. There was no reference to City Invoice withdrawing their credit facility.

36. In fact the figure of £185,632 was the net liabilities of the Company as at 31 March 2008 according to the draft accounts.

37. We accept Mr Jones' evidence that the real reason the directors consulted Clark Nicklin in January 2009 was the withdrawal of the credit facility by City Invoice. Brian Jones and John Smith gave unchallenged evidence to this effect. This was what caused the Company's downfall.

38. Mr Jones' tax return for 2007-08 was submitted in January 2009. It showed salary of £5,400 and dividends of £29,250. For Mrs Jones the figures were £5,400 and £15,750 respectively.

39. In January 2010 Mr Jones submitted his tax return for 2008-09. It recorded dividends as nil, salary from the Company of £226,010 and tax taken off amounting to £83,206. That is at least consistent with the payments having been reclassified as salary, however the declaration that tax had been deducted was untrue. The figures on the return resulted in a small repayment of tax to Mr Jones of £2,226. We accept that Mr Jones was advised by Clark Nicklin to include these figures on his tax return. He was certainly ill-advised to do so but we do not consider that he was deliberately seeking to deceive HMRC.

40. Mrs Jones returned dividends as nil, salary of £133,276 and tax deducted from salary of £45,528. She also obtained a small repayment.

41. Mr and Mrs Jones were fully aware that PAYE and national insurance had not been operated in relation to the dividend payments. They genuinely believed at the time of the payments that they were dividends and it was not necessary to deduct and pay tax and national insurance at the time the payments were made.

The Law

42. For tax purposes we are concerned with the *Income Tax (Pay As You Earn) Regulations 2003* ("the 2003 Regulations"). Regulation 72 applies where it appears that the amount deducted from "relevant payments" by an employer is less than the amount that was liable to be deducted. If Condition A or Condition B is met then HMRC may direct that the employer is not liable to pay the excess to HMRC. For present purposes we are concerned with Condition B in Regulation 72(4):

> "*Condition B is that [HMRC] are of the opinion that the employee has received* ***relevant payments*** ***knowing*** *that the employer* ***wilfully*** *failed to deduct the amount of tax which should have been deducted from those payments.*"
>
> (emphasis added)

43. Where HMRC wish to engage Regulation 72 on the basis that Condition B is satisfied they must issue a direction notice to the employee.

44. Regulation 4 defines "relevant payments" for the purposes of the 2003 Regulations as follows:

> "*…payments of, or on account of, net PAYE income …*"

45. *Section 683 Income Tax (Earnings and Pensions) Act 2003* defines PAYE income for present purposes as taxable earnings from an employment.

46. *Regulation 72C* provides for an appeal against a direction notice on the following grounds:

"*a) the employee did not receive the payments knowing that the employer wilfully failed to deduct the amount of tax which should have been deducted from those payments, or*

b) the excess is incorrect."

47. The tribunal is entitled to set aside the direction notice if it appears that it should not have been made.

48. For national insurance purposes we are concerned with the *Social Security (Contributions) Regulations 2001*. Regulation 86 provides that where there has been a failure to pay any primary contribution which a secondary contributor (the employer) would be liable to pay on behalf of the earner then in certain circumstances the liability of the employer is removed and the earner becomes liable for payment.

49. For present purposes the relevant circumstances are set out in Regulation 86(1)(ii) and arise where:

"*it is shown to the satisfaction of an officer of the Board that the earner **knows** that the secondary contributor has **wilfully** failed to pay the primary contribution which the secondary contributor was liable to pay on behalf of the earner …*"

50. The primary contribution is payable on earnings pursuant to the *Social Security Contributions and Benefits Act 1992*. By section 3(1), earnings are defined to include "*any remuneration or profit derived from an employment*".

51. *Section 8(1)(c) Social Security (Transfer of Functions etc.) Act 1999* makes provision for an officer to decide whether a person is or was liable to pay contributions of a particular class and if so the amount he is or was liable to pay. Section 11 of that Act then makes provision for an appeal to the tribunal.

52. We are also concerned in this appeal with the lawfulness of dividends.

53. As a matter of company law, dividends can only be paid where distributable profits are available by reference to the company's accounts. Sections 836 and 838 Companies Act 2006 set out the relevant accounts which are to be considered in determining the lawfulness of a distribution or dividend. No issue was taken by either party in relation to the formalities of declaring interim dividends.

54. We were referred to the HMRC Corporation Tax Manual which at CTM20095 has a commentary on the company law aspects of dividends. At [26] to [30] of that commentary reference is made to the treatment of unlawful dividends. At [29] it states as follows:

" *Where a dividend is paid and it is unlawful in whole or in part and the recipient knew or had reasonable grounds to believe that it was unlawful then that shareholder holds the dividend (or part) as constructive trustee in accordance with the principles stated by Dillon L J in Precision Dippings Ltd v*

Precision Dippings Marketing Ltd [1986] 1 Ch at page 457. Such a dividend (or part) is void for the purposes of [income tax] since the company has not made a distribution as a matter of company law … Where the company concerned is a close company, the company is regarded as having made a loan to the shareholder by virtue of ICTA88/S419 (2), thereby triggering a charge under ICTA88/S419 (1)."

55. We did not hear any argument as to the effect of an unlawful dividend. In Precision Dippings Ltd the Court of Appeal found that where an unlawful dividend was paid to a recipient with knowledge of the facts which made it unlawful the recipient holds it as a constructive trustee. That does not make it a loan, although for present purposes the effect may be the same. The recipient of an unlawful dividend has a liability to account to the Company.

Decision and Reasons

56. Dealing firstly with issues of law. Mr Davies on behalf of the Appellants submitted that in Regulation 72(4) of the 2003 Regulations the knowledge of the employee must be at the time the relevant payment is received by him. In other words, for Condition B to be satisfied the employee must know at the time payment is made that the employer has wilfully failed to deduct tax.

57. Both parties accepted that knowledge in Regulation 72(4) meant actual knowledge and wilfully meant deliberately or with intent.

58. Mr Davies submitted that Regulation 72 requires the following matters to be established before HMRC could give a direction notice pursuant to Regulation 72(5):

(1) Mr and Mrs Jones received a relevant payment;

(2) The Company failed to deduct tax when it should have done;

(3) The Company's failure was wilful;

(4) Mr and Mrs Jones at the time of the payment knew of the Company's failure and that it was wilful;

(5) That knowledge existed at the time the payments were received.

59. Mr Davies submitted that the requirements in the national insurance legislation were slightly different as follows:

(1) The Company had a liability to pay primary contributions on behalf of Mr and Mrs Jones;

(2) The Company wilfully failed to pay the contributions;

(3) Mr and Mrs Jones at the time the liability fell due knew that the Company had wilfully failed to pay that contribution;

60. Mr Davies' principal submission in relation to both pieces of legislation was that the conditions did not fall to be considered retrospectively. If there were no relevant payments at the time of payment, and therefore no obligation to deduct PAYE, there could be no liability on the part of Mr and Mrs Jones. Similarly in relation to the Company's liability to pay national insurance contributions.

61. It was common ground between the parties that dividends are not relevant payments for PAYE purposes and are not earnings for national insurance purposes.

62. Mr Boyle did not dispute Mr Davies' analysis and accepted that the conditions for liability did not fall to be considered retrospectively. Condition B falls to be considered at the time of payment. If the time of payment was when the funds were first made available to Mr and Mrs Jones, there could not have been a wilful failure to deduct and pay PAYE and national insurance. They were paid as interim dividends and no tax or national insurance was due.

63. Mr Boyle however submitted that the time of payment for present purposes was when the dividends were reclassified as salary. He accepted that Mr and Mrs Jones were entitled to withdraw income from the Company in the most tax efficient way. However he submitted that Regulation 72 and Regulation 86 would apply if there was a change of mind as to how payments should be classified.

64. Mr Boyle relied on a decision of the FTT in *Williams v Commissioners for HM Revenue & Customs [2012] UKFTT 302(TC)*. In that case Mr Williams received small payments of salary and much larger dividends, not unlike the present appeal. Mr Williams drew regular round sum amounts initially shown in the company's records as dividends. When the company went into liquidation Mr Williams sought to re-characterise the payments as salary. The FTT dismissed Mr Williams' appeal against a direction notice under Regulation 72. At [22] it found as a fact that:

> *"…it was always the intention of Mr Williams to cover his drawings by the payment of dividends … When it became apparent that [the company] had insufficient distributable reserves, and no doubt those behind the company having been advised that any such distribution would be closely scrutinised by any liquidator who might have to be appointed and would almost certainly result in its having to be repaid, an alternative method was sought to 'cover' the monies already withdrawn from the company.*"

65. The FTT found at [13] and [16] that at the time the drawings were made the company was in such a position that it could not lawfully have paid dividends and Mr Williams was aware of that fact. It went on to find at [28] to [30] that Mr Williams received the payments knowing that the company had wilfully failed to deduct tax and pay national insurance.

66. The decision in Williams is distinguishable on its facts from the present appeal. It seems from the decision that sums paid to Mr Williams were treated as drawings and debited to a loan account which thereby became overdrawn. The company intended in due course to vote a dividend to clear the loan account but it never did so

and could never have done so because it had insufficient distributable reserves. In the event it decided to treat Mr Williams as having received sufficient net salary as would clear the overdrawn loan account, knowing that the company would not account for PAYE and national insurance.

67. The obligation to deduct PAYE and pay national insurance arises at the time the earnings are paid to the employee. In the present appeal HMRC accept that the payments were dividends when originally paid. There was therefore no obligation to deduct PAYE and pay national insurance at the time those payments were made to Mr and Mrs Jones.

68. Mr Jones was confused in his evidence as to the reason the directors' loan account was overdrawn, and we share that confusion. He said that he thought reclassifying the dividends as salary would mean that the overdrawn loan accounts would not have to be repaid. However the payments were originally treated as dividends and so if anything would have given rise to a credit in the loan accounts. Reclassifying the payments as net salary would not cause an overdrawn loan account to come into credit. .

69. Mr Boyle submitted that the dividends had been reclassified as salary in order to clear overdrawn directors' loan accounts. In doing so he accepted that the payments to Mr and Mrs Jones were originally intended to be dividends and the Company had accounted for them as such. However when they were reclassified he said that the effect was to clear the overdrawn loan accounts. He submitted that the date of payment for PAYE and national insurance purposes was when the sums were credited to the directors' loan account

70. Mr Boyle submitted that an interim dividend, until it is a final dividend, is treated as a loan in the hands of a director. He provided no authority for that proposition and we do not think it is correct. The hearing bundle included guidance at [8] of CTM20095 which states as follows:

> " *A dividend is not paid and there is no distribution, unless and until the shareholder receives money or the distribution is otherwise unreservedly put at their disposal, perhaps by being credited to a loan account on which the shareholder has the power to draw.*"

71. It is useful to consider the accounting treatment. Where an interim dividend is paid there would be a credit to the cash account and a debit to the dividends paid account. If the dividends were not paid but simply made available to the directors then the credit would be to the directors' loan account. Reclassification would be effected by crediting the dividends paid account and debiting the wages account with the gross salary necessary to provide the net salary treated as being paid after deduction of PAYE and national insurance. At the same time the PAYE and national insurance would be credited to a separate account and show as a liability to HMRC. There was no evidence as to what accounting entries were made in January 2009 or subsequently. Indeed we have seen no accounting entries in the Sage accounts that bear on the reclassification.

72. The only way in which there would have been an overdrawn loan account would be if Mr and Mrs Jones were liable to repay the dividends because they were unlawful. Mr and Mrs Jones put their case on this appeal on the basis that the dividends when paid were lawful.

73. The hearing bundle included an analysis by Clark Nicklin of the directors' loan account apparently produced by them in January 2011. It showed an overdrawn balance of £40,599 as per the statutory accounts for the year ended 31 March 2007 and an overdrawn balance carried forward as at 31 December 2008 of £12,105. We did not have all the accompanying explanatory schedules. The basis of the analysis was far from clear and we are not satisfied that it is correct. For example it included entries for the Company's profit before tax and did not identify why such an entry should have appeared in the loan account. It also included "additional injections" which appear to be payments made by Mr and Mrs Jones in relation to personal guarantees after the Company went into liquidation.

74. Rather than clearing overdrawn loan accounts, it seems to us that Clark Nicklin were intending to prevent a liquidator from recovering what might be seen as unlawful dividends. The payments however had clearly been made as dividends. It was only if they were unlawful that they might properly have been repayable - either because they were to be treated as loans to the directors or because the directors were liable to account for them to the company. Mr and Mrs Jones did not address their minds in 2009 to whether there was a risk that the dividends might be repayable.

75. We have not been addressed in any detail at all as to the lawfulness of the dividends. On the evidence before us we have no reason to think that the interim dividends were unlawful. The lawfulness of the dividends at the time they were paid has not formed part of HMRC's decision making process or its submissions on this appeal. We have not seen the accounts available to Mr and Mrs Jones at the time the dividends were paid. Mr Jones gave evidence that he and Mrs Jones considered the position each month and only distributed dividends where profits were available. That evidence was not challenged and we accept it. Clark Nicklin did not raise any issue at the time of payment. It has not been suggested by HMRC in this appeal that the dividends were unlawful. In those circumstances we accept that the interim dividends were lawful when paid.

76. Mr Davies submitted that as the payments were dividends then the Company, which acted through its directors, could not have wilfully failed to deduct PAYE or pay national insurance and Mr and Mrs Jones could not have known of any failure, let alone that it was wilful. As we say, Mr Boyle did not take issue with that submission.

77. The first set of draft accounts for year ended 31 March 2008 clearly show only a nominal salary to Mr and Mrs Jones totalling £10,800. Interim dividends were £138,100. That is entirely consistent with how Mr Jones described the position.

78. We can see that Regulations 72 and 86 would apply on the facts of Williams as we understand them. That is because the salary was in fact paid at the time the drawings were made. The only explanation for the payments was that they were salary

because Mr Williams was aware that dividends could not lawfully be paid. He did not consider the payments to be loans. At the time of payment there was therefore a wilful failure to deduct PAYE and pay national insurance.

79. The position in the present appeal is different. It seems to us that the reclassification which occurred in the present case did not truly reflect the nature of the payments at the time they were made. The directors cannot retrospectively alter the nature of the payments simply by deciding to treat them differently. The payments were clearly made as interim dividends and taxable as such rather than as salary. Mr Boyle did not suggest otherwise, at least having regard to the position at the time of payment.

80. On the basis that the dividends were lawfully paid, the so-called reclassification in January 2009 would have no effect. Mr and Mrs Jones would have had no liability to the Company. They could not transform what had previously been received as dividends into salary unless there had been some error or misunderstanding at the time of payment.

81. If a company paid unlawful interim dividends the recipients would be liable to account. The company might recover the unlawful dividends by effectively making a payment of salary which after deduction of PAYE and payment of national insurance gave rise to an amount which would cover the dividends. It is at that time that the company would be required to deduct PAYE and pay national insurance. However that is not a reclassification of the original payment. It would amount to recovery by the company of the original payment together with a new payment of salary at the later date. That is how we understand Mr Boyle to put the case for HMRC. His submission however relies implicitly on the dividends being unlawfully paid in the first place.

82. We must ask ourselves what it was what the Company was intending to do in January and February 2009. No consideration appears to have been given by Mr and Mrs Jones at the time as to whether the interim dividends really were unlawful. They may have received advice that there was such a risk, but it is not clear to us that they understood any such advice. Indeed they have maintained in this appeal that the dividends were lawful.

83. There was no evidence that the reclassification in January 2009 was reflected in the Company's accounting records. In our view the reclassification amounted to nothing more than a flawed analysis of the transactions which had taken place. As such the reclassification did not give rise to any employment income or earnings in the hands of Mr and Mrs Jones at the time of the reclassification.

84. If the dividends had been unlawful then the position would have been different. At the time of reclassification Mr and Mrs Jones would have had a liability to account, settled when the dividends were reclassified as salary. We would then have to consider whether there was a wilful failure to deduct PAYE and pay national insurance at the time of the reclassification. It is not entirely clear that there would

have been such a wilful failure when a decision had already been taken to place the company into liquidation. However we do not need to address that issue.

Conclusion

85. On the facts as we have found them we do not consider that there was any obligation on the Company to deduct PAYE or to pay national insurance, either at the time of payment or at the time of reclassification. We therefore allow the appeal, set aside the direction notice and set aside the decision to make Mr and Mrs Jones liable for national insurance contributions.

86. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JONATHAN CANNAN
TRIBUNAL JUDGE

RELEASE DATE: 5 December 2014