

DECISION OF THE SOCIAL SECURITY COMMISSIONER

1. The claimant's appeal is allowed. The decision of the Bolton appeal tribunal dated 28 June 2002 is erroneous in point of law, for the reasons given below, and I set it aside. It is expedient for me to substitute the decision which the appeal tribunal should have made on the claimant's appeal against the decision dated 3 January 2002, having made the necessary findings of fact (Social Security Act 1998, section 14(8)(a)(ii)). My decision is that the claimant is entitled to working families' tax credit on the claim treated as made on 6 December 2001 at a weekly rate and for a period to be calculated by the Board of Inland Revenue on the basis set out in paragraphs 24 to 26 below. If there is any disagreement on the results of that calculation, the appeal may be returned to me (or, if necessary, another Commissioner) for further decision.

2. This case arises from the claim for working families' tax credit (WFTC) which was initially treated as made on 21 November 2001. That was the date on which a claim form had been requested in a telephone call. The form was returned, signed on 6 December 2001, to arrive on 10 December 2001. On the claim form, the claimant stated that he was an employee, employed by Flowtech Design Ltd, normally working for 15 hours a week. He said that his hours had changed on 5 September 2001. He stated that his wife was an employee, employed by the local authority at a school, normally working for 26¼ hours per week. The claimant also ticked that he and his wife were directors of a limited company and had been since 28 January 1991. Payslips for his wife's employment were enclosed. The claimant stated that he had last been paid on 24 August 2001, for the month ending 5 September 2001 (and enclosed that payslip), but had not received any payment for September, October or November. He said that he was working unpaid for 15 hours a week trying to promote the company and get work in, but did not know how long he could keep going.

3. Because of the answers about being directors, forms WFTC272, asking about hours and earnings as a director, were sent to the claimant and his wife. They were both directors of Flowtech Design Ltd. His wife said that she was a director in name only, did not work for the company and received no earnings. The claimant filled in the form by answering the questions about work as a director. He stated that he started work as a director on 28 January 1991, normally working 40 or more hours a week, but only 15 hours in any weeks starting with 20 October 2001, the change having occurred on 5 September 2001. He stated that he was not paid for hours worked from 18 November 2000 to 5 February 2001 or from 5 September 2001 onwards. The company could not afford to pay any salary at the present and he did not know when payment might start again. His actual gross income in the year from 18 November 2000 to 17 November 2001 was £24,000. He described his position in the company as technical consultant. He also wrote that he wished the application date to be 6 December 2001, as at that date he had not received any payment in the previous three months.

4. On that information, a representative of the Board of Inland Revenue (the Board) disallowed the claim on 3 January 2002. The special rule for earnings from employment as a director in regulation 14A of the Family Credit (General) Regulations 1987 was applied. That rule requires normal weekly earnings from such an employment to be determined by taking

account of the earnings from that employment received in the year immediately preceding the week of claim. Earnings from employment as a director are taken out of the usual rules for calculating normal weekly earnings from employment as an employed earner, which are in regulation 14. The claimant's earnings over the past year, converted to a weekly figure, took the family's total income over the maximum figure at which WFTC could be awarded. On the information then provided, and given the way in which the claimant had filled in the form WFTC272, I do not see how any other decision could have been reached (although if information given on past claims had been consulted, doubts might have been raised).

5. The claimant then made a request for an explanation, stressing that he had had no earnings after 5 September 2001. He seems to have been sent another form WFTC272, which was filled in and signed on 23 January 2002. The replies were essentially the same, although the claimant wrote "please do not treat my earnings as 'self-employed'. I am an employee." It seems to be at this point that a copy of the directors' reports and financial statements for Flowtech Design Ltd for the year ended 31 May 2002 was sent with the form. The directors' report showed that the claimant and his wife were the only shareholders, he having 600 of the issued ordinary shares and his wife 400. They were also the only directors. The principal activity of the company was computer consultancy. The trading and profit and loss account showed directors' remuneration separately from wages. For the year to 31 May 2001, the figure for directors' remuneration was £18,000 and for wages was £1,821 (2000 figures, £20,425 and £2,378). Pensions and social security were shown separately.

6. On that further information, the Board (not surprisingly) declined to change its decision on looking at it again. The claimant then appealed, after some further telephone conversation with the Tax Credit Office. That was the first time at which the claimant expressly raised in writing the point that he had not received earnings as a director, but as an employee. He also argued that there was discrimination if people who happened to be directors were treated less favourably than "ordinary" employees and that the family had been awarded family credit and WFTC in very similar circumstances in 1999 and 2000. The claimant put together a detailed written statement in support of his argument that he was an employee of the company and was paid only in that capacity. He provided copies of the directors' reports and accounts for the year ending 28 February 1999 and the 15 months ending on 31 May 2000, in which there was no item for directors' remuneration, but the figures for wages were £16,679 and £24,653. He explained that the company's accountants had used a different method of presenting information and that he had not noticed that his earnings had been put into a different, inaccurate, category. He supplied copies of payslips from May to September 2001, showing deductions of income tax under PAYE and national insurance contributions.

7. The claimant attended the hearing on 28 June 2002 and gave detailed evidence. He said that there had been no change in his status in relation to the company, as an employee, but he thought that the accountants might have used a different computer package. He also said that in September 2001 he had had to do a VAT return, which made him realise that there was no money in the company to pay any salary.

8. The appeal tribunal disallowed the claimant's appeal. It said in its statement of reasons that the claimant and his wife were directors of Flowtech Design Ltd and that that meant that their earnings from the business fell to be calculated in accordance with regulation 14A of the Family Credit Regulations. It referred to the claimant's argument that he was an employee of the company and continued:

"Clearly, however, [the claimant] is a director of the company. The legislation governing WFTC does not differentiate between directors per se and directors who are employees of the company. Therefore his income for the period in question is to be treated as the income of a director and assessed according to reg 14A on an annual basis."

I note that the appeal tribunal found as a fact that the company was in financial difficulties and that therefore it was not possible to pay the claimant his salary after 5 September 2001.

9. The claimant now appeals from that decision with my leave. The appeal is supported on behalf of the Board in the submission dated 30 November 2002 (which for some reason was not received in the Commissioners' office when originally sent, the replacement not arriving until 10 January 2003). It is plain that the appeal tribunal's decision was based on a false proposition of law. There is nothing in law to prevent a person who holds the office of a director of a limited company from also having a contract of employment with the company. Regulations 14 and 14A of the Family Credit Regulations clearly apply the special rule in regulation 14A only to a person's earnings from employment as a director. Therefore it was necessary for the appeal tribunal to make findings of fact as to whether the claimant's earnings were from employment as a director or, as he contended, from employment as an employee of the company. There were errors of law in the appeal tribunal's failing to make such findings and in its adoption of a false proposition of law in rejecting the claimant's contentions.

10. For those reasons, the appeal tribunal's decision is set aside as erroneous in point of law. The representative of the Board initially submitted that the case should be remitted to a new appeal tribunal to make the necessary findings of fact and suggested that evidence could be obtained from the company's accountants. I suggested, when formally validating the Board's late submission that the claimant might wish to put forward in evidence, say a contract of employment or evidence from the accountants, and request me to substitute a decision. The claimant did make such a request in his reply dated 12 February 2003, with which he enclosed a copy of the minutes of the annual general meeting of Flowtech Design Ltd for the year ending 29 February 1996. There was the following minute under "any other business":

"It was proposed and agreed that [the claimant and his wife] be entitled to an annual salary greater than the National Insurance threshold to be paid as and when cash flow in the company so permits."

He said that he understood that resolution as meaning that he and his wife were salaried employees of the company. His only duties as a director were to complete official documents as and when required. His duties as an employee were to undertake the normal day-to-day

activities required to keep the business trading (undertaking projects, chasing potential sales, administrative duties etc).

11. That evidence does not take matters much further forward. However, after some thought over whether to send the case back to a new appeal tribunal after giving the claimant the opportunity to produce more documentary evidence, I concluded that there is sufficient evidence for me to make a decision in this case on the employee/director issue.

12. I need first to look briefly at the case-law on the circumstances in which directors of small limited companies can be shown to be employees of the company. The employment tribunals and the courts have had to consider this issue quite frequently in the context of entitlement to compensation on redundancy or for unfair dismissal. The leading recent case is Secretary of State for Trade and Industry v Bottrill [2000] 1 All ER 915, but the general principles were established by the Privy Council as long ago as 1960 in Lee v Lee's Air Farming Ltd [1961] AC 12. There Mr Lee was the major shareholder (2999 out of 3000 shares) and "governing director" of the company, which carried out aerial top-dressing. He was also employed by the company as chief pilot "at a salary to be arranged by the governing director". He was killed in an accident while working. The question was whether he was a workman for the purposes of a New Zealand statute on compensation. The Privy Council held that he was, stressing that he and the company were separate persons in law. The mere fact that someone was a director of a company was no impediment to the person entering into a contract to serve the company. Nor did the fact that Mr Lee was the governing director mean that the company did not have the right to control him as an employee.

13. Bottrill was an unfair dismissal case. The Lord Woolf MR in Court of Appeal said:

"We do not find any justification for departing from the well-established position in the law of employment generally. Thus whether or not an employer and employee relationship exists can only be decided by having regard to all the relevant facts. If an individual has a controlling shareholding is certainly a fact which is likely to be significant in all situations and in some cases it may be decisive. However, it is only one of the factors which are relevant and certainly is not to be taken as determinative without considering all the relevant circumstances."

He then rejected cases which appeared to say that a controlling shareholder could not be treated as an employee, especially in cases where a decision to dismiss the person was in issue. Lord Woolf went on to suggest some questions which might be relevant in other cases:

"The first question which the tribunal is likely to wish to consider is whether there is or has been a genuine contract between the company and the shareholder. In this context how and for what reasons the contract came into existence (for example, whether the contract was made at a time when insolvency loomed) and what each party actually did pursuant to the contract are likely to be relevant considerations.

If the tribunal concludes that the contract is not a sham, it is likely to wish to consider

next whether the contract, which may well have been labelled a contract of employment, actually gave rise to an employer/employee relationship. In this context, of the various factors usually regarded as relevant (see, for example, Chitty on Contracts, 27th edn (1994) vol 2, pp 703-704, para 37-008), the degree of control exercised by the company over the shareholder employee is always important. This is not the same question as that relating to whether there is a controlling shareholding. The tribunal may think it appropriate to consider whether there are directors other than or in addition to the shareholder employee and whether the constitution of the company gives that shareholder rights such that he is in reality answerable only to himself and incapable of being dismissed. If he is a director, it may be relevant to consider whether he is able under the articles of association to vote on matters in which he is personally interested, such as termination of his contract of employment. Again, the actual conduct of the parties pursuant to the terms of the contract is likely to be relevant. It is for the tribunal as an industrial jury to take all relevant factors into account in reaching its conclusion, giving such weight to them as it considers appropriate."

14. The approach in Bottrill was approved and applied by the Court of Appeal in Sellars Arenascene Ltd v Connolly [2001] EWCA Civ 184 [2001] IRLR 222 and by the Employment Appeal Tribunal in Hauxwell v Secretary of State for Trade and Industry (19 June 2002). I adopt it in the present case. I note also that the Court of Appeal in Bottrill considered it relevant that there were provisions in the relevant legislation limiting the scope for abuse. In the context of WFTC there is a provision limiting abuse in regulation 26(4) of the Family Credit Regulations, which I shall come back to below.

15. There is an initial difficulty here in that there is no evidence of the existence of a written contract of employment between the claimant and Flowtech Design Ltd nor of the existence of a written memorandum of the terms and conditions. Where a director of a limited company has a service contract with the company a copy of such a memorandum, or of the contract if it is in writing, is supposed under section 318 of the Companies Act 1985 to be lodged at a place where it can be examined. However, there is no requirement in the general law that a contract of employment has to be in writing. I am satisfied that there was a contract formed between two legally separate persons between the claimant and the company. I do not find the resolution at the annual general meeting for the year ending 29 February 1996 much help. It could have related to a payment of salary as a director, or even be taken as indicating that the claimant did not already have any entitlement to remuneration stemming from a contract of employment. I take the resolution merely as indicating the basis on which the claimant and his wife would take remuneration. Nor is the deduction of income tax under PAYE and of national insurance contributions much help. The same deductions would have been required if the claimant received remuneration as a director. The claimant's understanding, which I accept has been consistent throughout, that his salary was to be received as an employee of the company is of more significance.

16. I put most weight on some information given in the accounts before 2000/2001. The claimant has pointed out that on pages 84 and 100 in the trading and profit and loss accounts for the years to 28 February 1999 and 31 May 2000 there was one category for wages or wages and

salaries, with no separate category of directors' remuneration. The force of that is greatly weakened by notes 3 and 4 to the accounts (pages 86 and 97) which say that the operating profit was stated after charging, among other items, staff costs, which included directors' remuneration. The great bulk of staff costs in the form of wages and salaries etc was made up of directors' remuneration, £15,750 out of £18,165 in 1999 and £20,425 out of £25,300 in 2000. Thus, the profit and loss accounts are, it seems to me, neutral on whether remuneration was paid to the claimant as a director or as an employee who happened also to be a director. However, at the end of note 4 is a statement that the average weekly number of employees during the accounting period was two for 1999 and three for 2000. The claimant must, taking account of the amounts involved, have been included in that number. And I think that that is consistent with what he has said about employing his son in return for the payment of small amounts below the income tax threshold. There was no similar statement in the notes to the 2001 accounts, but I am satisfied that there was no change in the contractual arrangements.

17. I conclude from the accountants' statements mentioned above that they regarded the claimant as an employee of Flowtech Design Ltd and therefore as having a contract of employment with the company. They also regarded the claimant's remuneration as paid in return for the performance of his duties as an employee and not in return for the performance of his duties as a director. There is some doubt whether the terms of any contract were sufficiently clearly defined that there was an enforceable contract. There is scarcely any evidence of the duties required of the claimant and the apparent term defining pay was very vague indeed. However, I note that in *Lee's* case the Privy Council accepted as having legal effect a contract under which Mr Lee's pay as an employee was to be determined by himself in his capacity as governing director. It seems to me that, once it is accepted that there can be a contract of employment between a company like Flowtech Design Ltd and a controlling shareholder who is also a director, a term that the company will set the level of remuneration under the contract from time to time depending on cash flow is acceptable. Here, it seems that the claimant's remuneration of £3,000 per month had been set in advance by the company until it was decided that no remuneration could be paid after 5 September 2001.

18. Thus, in terms of Lord Woolf's questions in *Bottrill*, I am satisfied that there was a genuine contract between the company and the claimant. I am also satisfied that the contract gave rise to an employer/employee relationship. Taking into account what was said in *Lee's* case and the skills and expertise involved in the claimant's work, the company retained the right to control his activities as an employee. I conclude that the claimant was an employee of the company and received his remuneration as an employee, not as a director. The Board was given the opportunity, in the procedure described below, to comment on my provisional conclusion to that effect. It did not do so.

19. The application of the Family Credit Regulations in the light of that conclusion of fact is not entirely straightforward though. The claimant's argument is that the normal calculation in regulation 14 should be used, in his case as monthly paid and using the amounts received in the three months immediately before the week of claim. When I started to work out the consequences, based on a date of claim of 21 November 2001, the result appeared in fact to make the claimant worse off. The three months before the week of that claim covered the

payment made for the month to 5 September 2001 (whether it was received on 24 August 2001 or 5 September 2001), which would have to be taken into account. The operation of the averaging and calculation process in regulation 20(5) left the amount paid for the month to 5 September 2001 to be used as the average monthly earnings. That would translate to a weekly figure too high for entitlement to WFTC. I set out the details in my direction dated 18 March 2003 and do not need to repeat them here. I therefore directed an oral hearing, to give the claimant an opportunity to deal with that potential outcome. I also asked a number of questions about the apparent application of regulation 6(1)(aa) of the Social Security (Claims and Payments) Regulations 1987 on the date of claim and about whether the date of the claimant's telephone call to request a claim form had to be accepted as the date of claim.

20. Before the date fixed for an oral hearing, the representative of the Board made a very helpful written submission, dated 7 April 2003, suggesting that the case could be decided in the claimant's favour without the need for an oral hearing. The claimant agreed to the cancellation of the oral hearing, but wished to be given time to reply in writing to the submission of 7 April 2003. His reply was dated 12 May 2003.

21. The submission on behalf of the Board pointed out that regulation 6(1)(aa) of the Claims and Payments Regulations had been amended for the purposes of WFTC and disabled person's tax credit with effect from 10 April 2001 to remove the references to those two credits and that new paragraphs (1B) and (1C) had been inserted from the same date. That is something of which I should have been aware. Because those amendments did not appear in the standard collection of social security legislation used by Commissioners, appeal tribunals and others (although it does appear in the Stationery Office blue volumes, with a printing error), I set out the new paragraphs of regulation 6 here:

"(1B) Subject to paragraph (1C), in the case of a claim for working families' tax credit or disabled person's tax credit which meets the requirement of regulation 4(1) and which is received in an appropriate office within one month of first notification in accordance with regulation 4(5)--

- (a) where the claimant is entitled to that credit on the date on which that notification is received ('the notification date') and the first day of the period in respect of which that claim is made is on or before the notification date, the date on which a claim is made shall be the notification date; or
- (b) where the claimant is not entitled to that credit on the notification date but becomes so entitled before the date on which the claim is received, the date on which a claim is made shall be--
 - (i) the date on which the claimant becomes so entitled, or
 - (ii) if later, the first day of the period in respect of which the claim is made provided that it is not later than the date on which the claim is received.

(1C) Paragraph (1B) shall not apply in the case of a claim which is received in an appropriate office--

- (a) in the case of working families' tax credit, within the period specified opposite that credit at paragraphs (a) or (aa) in column (2) of Schedule 4; or

(b) in the case of disabled person's tax credit, within the period specified opposite that credit at paragraphs (a) or (b) in column (2) of Schedule 4, unless the previous award of working families' tax credit or disabled person's tax credit was terminated by virtue of regulation 49ZA of the Family Credit (General) regulations 1987 or regulation 54A of the Disability Working Allowance (General) Regulations 1991."

22. I agree with the Board's representative that the present case seems to fall precisely within the scope of regulation 6(1B)(b). Regulation 6(1C) is not relevant because that only excludes the operation of paragraph (1B) in cases of renewal claims. The claim form was received properly completed within one month of 21 November 2001, the notification date, but there was no entitlement to WFTC on that date. If the claimant would be entitled to WFTC from some later date before 10 December 2001, then the appropriate later date would be the date of claim under head (i) or (ii) of paragraph (1B)(b). However, the precise dates need to be looked at with particular care. The Board's representative submitted that the date of claim was to be taken as 10 December 2001 under paragraph (1B)(b)(i), but I am not at all sure how that ties in with the rules in regulation 16(1) and (3) about the day of the week (Tuesday) on which the right to payment of WFTC can begin. There may be some doubt about the meaning of regulation 6(1B) in talking of entitlement on particular dates.

23. As it turns out, the issue can be simplified slightly by a further finding of fact. The Board's representative was working on the basis that the last actual payment of monthly salary to the claimant was made on 5 September 2001. The claimant has throughout said that the last payment of salary covered the period to 5 September 2001, but has also said that the payment was made on 24 August 2001. There have been some slight confusions in the form of words used, but I accept that that was the case. It is common for employers to make payments of monthly salary before the end of the month to which the payment relates and there is no reason to reject what the claimant has said on this point.

24. Regulation 14(1) of the Family Credit Regulations works on payments received in the assessment period. In the claimant's case the assessment period would be the three consecutive months immediately preceding the (Sunday to Saturday) week of claim. If the week of claim ran from 18 November 2001 to 24 November 2001, the payment received on 24 August 2001 would just be within the assessment period. If the week of claim ran from 25 November 2001 to 1 December 2001 or later, that payment would be excluded and no payment would actually have been received in the assessment period, so that potentially (subject to a point discussed below) there would be entitlement to WFTC. That takes the case out of regulation 6(1B)(a) and into regulation 6(1B)(b). The claim form received on 10 December 2001 stated no period of claim, there being no question about that. But the claimant's reply on the WFTC272 form signed on 21 December 2001, saying that he wished the application date to be 6 December 2001, operated as an amendment of the claim (see regulation 5). I interpret that amendment as a statement that the claimant wished to claim in respect of the period beginning on 6 December 2001. That takes the case out of head (i) of regulation 6(1B)(b) and into head (ii). The date of claim would therefore be 6 December 2001 and the week of claim would run from 2 December

2001 to 8 December 2001. The calculation of earnings would then exclude the payment received on 24 August 2001.

25. The additional point to be considered is the potential application of regulation 26(4) of the Family Credit Regulations on notional earnings where a person performs a service for another person and receives no earnings or less than the going rate. The claimant mentioned in his letter dated 12 May 2003 the effect of an application of the equivalent rule for the purposes of jobseeker's allowance and being treated as if he were receiving the national minimum wage for the hours worked. The basic condition in regulation 26(4) would be met because the claimant was providing services for Flowtech Design Ltd, a separate person in law. But it is also a condition for treating a person as receiving such earnings as are reasonable for the employment that it is shown that the means of the person for whom the services are provided are sufficient to pay or to pay more for the services (regulation 26(4)(c)). In the present case, the appeal tribunal found as a fact that the company was in financial difficulties and was not able to pay the claimant his salary after 5 September 2001. There was evidence to support that finding, which I accept and adopt. An essential condition for the operation of regulation 26(4) is therefore missing and the claimant is not to be treated as possessing any notional earnings.

26. Accordingly, in the assessment period as identified in paragraph 24 above the claimant received no earnings and is entitled to WFTC from the date appropriate to his claim being treated as made on 6 December 2001. The amount of WFTC is to be calculated by the Board as suggested in the submission of 7 April 2003. If there is any disagreement as to the result of that calculation or as to the effective date of the award, the case is to be returned for further decision. My decision giving effect to those conclusions is set out in paragraph 1 above.

(Signed) J Mesher
Commissioner

Date: 7 July 2003