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INSOLVENCY

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INSIDE:

The (Insolvency) Empire Strikes Back

Two recent High Court cases last year up-ended the prevailing wisdom on how liquidators could use the claw-back provisions of the Companies Act.

In response, two liquidation firms, with the quiet backing of the rest of the insolvency industry, watched anxiously as Brian Keene QC took the matter to the Court of Appeal. Below is a summary of the twists and pivots of how the insolvency empire was nearly brought undone by Fences and Kerbs.

PARI PASSU

At the heart of modern insolvency is *pari passu*, Latin for *equal step*. Each creditor in an insolvency should be treated the same as every other creditor with the same rights. When an insolvency practitioner becomes in charge of an estate, either a bankrupt person or a liquidated company, they must apply the *pari passu* rule when making a distribution to creditors. It is not possible to favour one creditor over another if they have the same rights. This article shall refer to a liquidated company but the rules are almost identical for a bankrupted person.

CREDITOR CLASSES

Creditors come in three categories when it comes to their rights.

Secured creditors; who have a financial interest in an asset, or a General Security Agreement (G.S.A.) over the entire estate.

Preferential creditors; such as staff for unpaid wages and the IRD for unpaid PAYE and GST.

Unsecured creditors; who have no security or preference and must wait until all other creditors have been satisfied before receiving any distribution.

The general rule is secured creditors get looked after first. What is left is then used to pay preferential creditors and anything left over is divided up between the unsecured creditors.

INSOLVENT TRANSACTIONS

In the dying months of a company's life some creditors can get their old debt paid, giving them an unfair preference over other creditors. If the transaction that lead to this unfair preference meets the test of being an insolvent transaction, it can be voided. An insolvent transaction is one that;

A) Happened when the company was insolvent

B) Happened in the last two years before liquidation

C) Allowed one creditor to gain an unfair preference over other creditors

A transaction is defined widely but in practical terms it usually means the insolvent company paying a creditor for an old debt. If a liquidator can show that the transaction meets all three of these requirements he can demand that the money be repaid.

THE RUNNING ACCOUNT

A creditor having their money recalled has two lines of defence. The first is the 'running account'; defence.

The insolvent transactions regime was overhauled in 2008. The much litigated 'ordinary course of business' was replaced with 'the running account'. It was based on Australian legislation and was commonly understood to mean that if you traded with an insolvent company you could get paid for the work you did, but if you were paid for work previously completed it could be clawed back.

As an example; if you are a butcher and you are supplying meat to a cafe. The cafe owes you a thousand dollars for meat supplied six months ago yet they come crawling back asking for some more product. You agree, selling them five hundred dollars worth of meat but only if they pay you the outstanding account, which they do. The cafe goes into liquidation the following month.

The liquidator will be able to demand you repay the thousand for the old debt, but not the five hundred for the goods provided prior to liquidation.

The running account is not really a defence; it is more about defining the level of the insolvent transaction.

THE TRINITY

Once the running account analysis has defined the amount of the voidable preference a creditor has a three stage defence to a liquidator's demand that the money be paid back. All three defences must be met and this is outlined in Section 296 (3) of the Companies Act;

The Court must not order the recovery … if the person whom recovery is sought (A) proves that ***when*** *A received the property it;*

A) .. acted in good faith; and

B) .. did not have reasonable grounds for suspecting ..the company… was insolvent .. and

C) ***.. gave value***

Emphasis added.

Here things get interesting. In July 2010 Associate Judge Christiansen examined these issues in the McEntee Hire case and he said this:

> *"..if during that period there has been an increase in indebtedness to the creditor it usually means there is no voidable transaction. On the other hand a net reduction in indebtedness would normally indicate the opposite."*

Christiansen went further, saying that a liquidator could choose the point of trading between the debtor and creditor to maximise the amount to be voided; the 'point of peak indebtedness' rule. McEntee lost because the court found he should have known the company who was paying him was insolvent. The issue of the timing of *gave value* was canvassed but it was tangential to the case.

The judgement was welcomed by liquidators and gained some media commentary at the time as Bill McEntee decried that the judgement was 'totally unfair' and was planning a crusade against the insolvent transactions law. He subsequently sold his business to Kennards and moved on to other projects.

In November 2012 Christiansen returned to the area. The meaning of the words 'gave value' was now the focal point. It was accepted that the creditor acted in good faith and did not suspect insolvency. The Associate Judge had this to say in the Farrel v Fences and Kerbs case;

> *"..the court does not accept that s 296(3)(c) requires that the giving of value must occur from the time that the payment is made."*

In this case, and in a subsequent judgement Christiansen ruled that the giving of

The cute yoda-like creature is a Tarsier. It is the only living primate that is exclusively carnivorous. No salad for this tiny monkey; strictly insects and small birds. They hunt by jumping at night, assisted by their huge eyes. Baby Tasriers waste no time and are able to climb within a day of being born. Their habitat is mostly confined to Malaysia and the Philippines.

value can occur at any time. This made the running account seem pointless, because if the single transaction goes back to the start of the transaction, there can never be anything to void.

He was supported by Justice Toogood in the Hiway Stabilizers case who stated:

> *"There is no reason in either logic or policy why a supplier of goods or services who meets the first two limbs of the defence should be deprived of the defence merely because the supply has been made prior to the impugned payment"*

Christiansen and Toogood looked at the meaning of the words 'gave value' and saw that it was past tense. There was no time restriction on when value could be given. The Australian legislation is better drafted and its meaning more direct and on a literal reading of the act their decisions make sense.

To highlight the uncertainty between prevailing wisdom and that the legislation, Toogood refers to Heath and Whale:

> *"The concept of value is to be evaluated in the context of the section; accordingly it is likely that only any new value given by the other party to the transaction will be considered under this section."*

Toogood took the legislation to mean what it said.

The Court of Appeal dealt with this issue with such rapid speed there was several ACC claims for judicial whiplash.

The two liquidators involved, Meltzer Mason Heath and Kelman and Co, joined forces in the Appeal.

THE LIQUIDATORS WON AND IT CAME DOWN TO THIS;

Christiansen and Toogood looked at the words *gave value* and concluded that this meant the creditor could have given value at any time. The Court of Appeal looked at the word *when* in the header paragraph and concluded that this defined when the creditor can have given value.

When Heath and Whale said the concept of value is to be evaluated in the context of the Section, they were looking at the word *when*, as did the Court of Appeal.

The Court also looked more widely at the history of the *pari passu* principle and the importance of maintaining the preference between the different classes of creditors. If an unsecured creditor can recover their debt in advance of liquidation this can mean that the pool of assets to pay for preferential creditors is diminished. The importance of the voidable preference regime is to protect the statutory allocation of distributions and the Court was clearly keen to maintain this regime.

CREDITORS BEWARE

Although the Christiansen and Toogood cases threw a chill over the insolvency profession, the rapid intervention of the Court of Appeal has restored the status-quo.

Creditors who trade with insolvent companies can do so with confidence if they get paid for the work that they do when they do the work. If the company is insolvent and the creditor succeeds in recovering old debts there is a risk of getting a claw-back letter from a liquidator.

For those chasing debts from clearly insolvent companies, this poses some challenges but three things are important to remember:

- Not all insolvent companies go into liquidation and even if they do, there can be a long delay. Money recovered two years before liquidation (or when liquidation proceedings are instigated) cannot be clawed back.
- Not all liquidators do the analysis needed to find insolvent transactions, so you can get your money and hope for the best.
- Liquidators will almost always settle for a percentage of the amount owing. Commercial and legal reality means it is usually better to settle than litigate.

IRD Disputes Resolution Process

By Kirsten Smith

Disputing an assessment with the Inland Revenue Department ("IRD") can be a complicated and often challenging experience. Knowing the process you need to follow and the rigid timeframes involved is most important.

If you have have received a Notice of Assessment and you do not agree with it, knowing the correct disputes process can save you time and money:

1. NOPA

When disputing an assessment that the IRD have kindly decided for you, you must send a Notice of Proposed Adjustment ("NOPA") within four months of receiving the assessment. The form you need to complete is an IR 770 and is not overly complicated. However, it is important to complete it correctly so assistance from your accountant or lawyer may be beneficial.

If you are lucky, the IRD will accept your adjustments and the assessment will be reissued. Far more likely is the IRD will disagree with some or all of your proposed adjustments and it is on to step 2.

2. NOR

The IRD has two months from the date of the NOPA to send a Notice of Response ("NOR") providing an explanation of why they disagree with your proposed adjustments as set out in your NOPA. They may also suggest ways the adjustment could be amended that is satisfactory for the IRD.

If you disagree with the IRD's NOR you must put this in writing within two months from the date of issue and step three begins.

3. A Date with the IRD

A meeting with the IRD will take place, either in person or over the phone. The meeting will cover the issues both parties have outlined and a compromise will attempted to be reached. If this does resolve things you will need to go to step 4.

4. Disclosure notice and statement of position

The IRD will send you a disclosure notice which requires you to write a Statement of Position within two months. This requires an outline of the facts, evidence and propositions of law. It is important to include all the material that supports your argument as you cannot add to this at a later date.

The IRD will also send their Statement of Position within the two month timeframe.

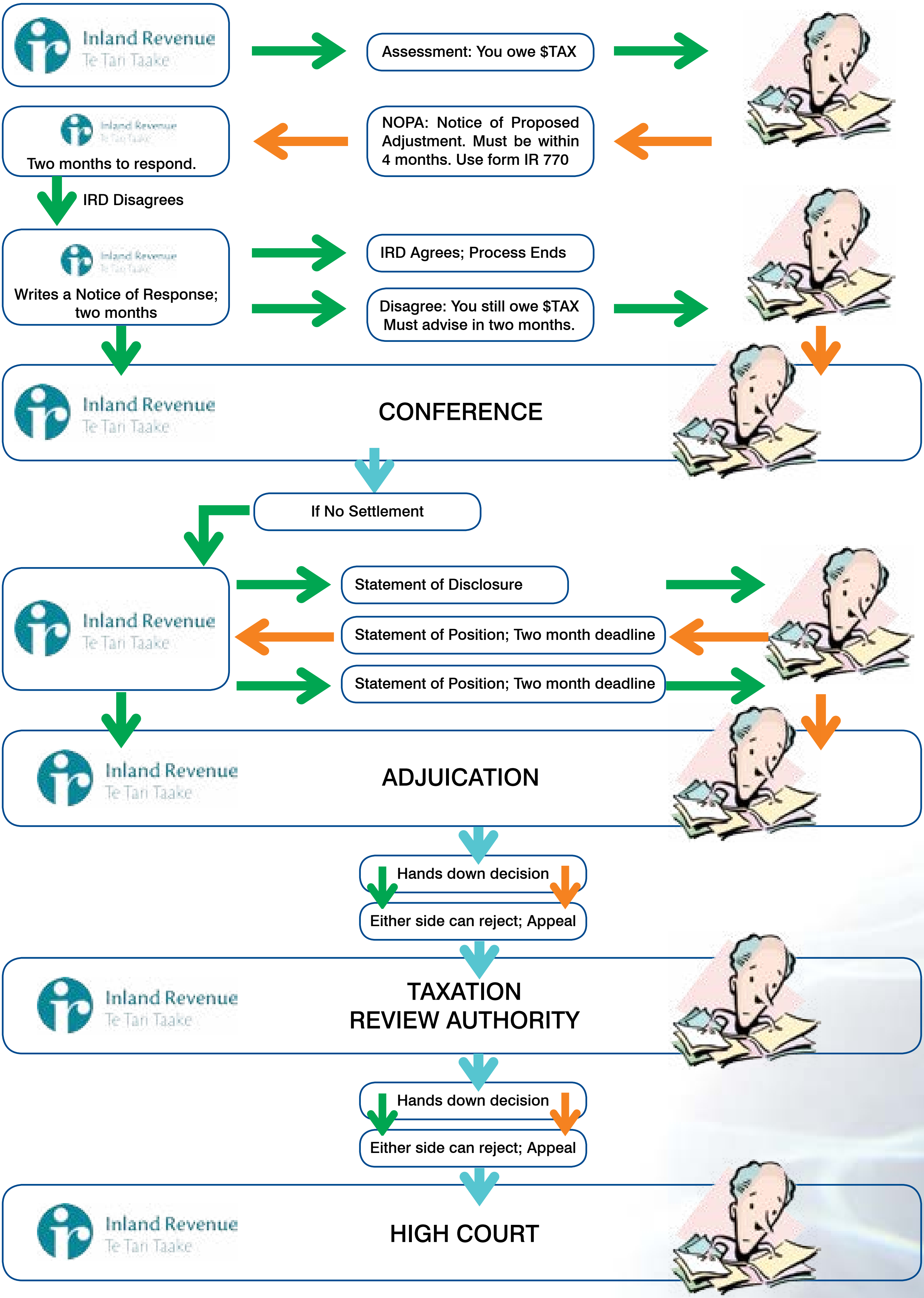
5. Adjudication

The adjudicator is an independent expert from within the IRD and has no previous relationship with the dispute or the disputing parties. The independent adjudicator will review both parties' statements of position and will consider the issues with regard to the relevant laws. The adjudicator will finalise their opinion on which party's argument holds the most merit and a confirmation letter is sent to both parties. Usually both parties will accept the adjudicator's decision and the matter ends there. However if you disagree with the decision you may petition your case with the Taxation Review Authority ("TRA") or the High Court.

6. Taxation Review Authority or the High Court

If you should choose to further dispute the Commissioner's decision with regard to your tax return you may elect to appeal to the TRA. The TRA consists of one District Court Judge who hears all tax issues raised for any amount disputed. The hearing will take place with your legal representative and the IRD's stating their case with supporting evidence for the Judge to consider. While costs are unable to be awarded against you in the event you lose, they are able to be awarded if the judge considers your claim to be vexatious or frivolous. If you are unsuccessful at the TRA, you can appeal this to the High Court.

His NOPA was rejected and he is unhappy with the NOR.


Inland Revenue
Te Tari Taake
Assessment: You owe $TAX
NOPA: Notice of Proposed Adjustment. Must be within 4 months. Use form IR 770
Two months to respond.
IRD Disagrees
Writes a Notice of Response; two months
IRD Agrees; Process Ends
Disagree: You still owe $TAX Must advise in two months.
CONFERENCE
If No Settlement
Statement of Disclosure
Statement of Position; Two month deadline
Statement of Position; Two month deadline
ADJUICATION
Hands down decision
Either side can reject; Appeal
TAXATION REVIEW AUTHORITY
Hands down decision
Either side can reject; Appeal
HIGH COURT

Looking Through to a New Era of Tax Entities

Look Through Companies ("LTC") have replaced the Loss Attributing Qualifying Companies ("LAQC") and Qualifying Companies ("QC").

The LAQC regime allowed PAYE tax payers to manufacture losses in their LAQC businesses and deduct these losses against their income, in return they were personally liable for their share of the companies income tax, if any. The IRD felt some tax payers were abusing this by placing rental properties into an LAQC, deducting the annual cash losses but not paying tax on the capital gains on the property.

Legislation introduced by the New Zealand Government in April of 2011 ended the LAQC regime, replacing it with the LTC.

The Look Through Company ("LTC") regime sees a much more restrictive mechanism to pass income and expenditure through to shareholders with the main difference being that in a LTC the amount of tax losses that can be deducted is restricted to the actual investment made by the tax payer into the company.

This cap is the 'Owners Basis' and is defined as:

Investments made and income earned

minus

Distributions, deductions and disallowed amounts

equals

Owner's basis

A significant difference between the two regimes is the loss limitation rules, which did not exist in the old regime. These restrict the amount of losses a shareholder may off-set against their other income. This is referred to as the *owner's basis* and takes into account equity, assets and loans introduced to the company.

The LTC is ignored for income tax purposes with all taxable income, expenditure and credits shifting to the shareholders; based upon their effective shareholding in the company. The company however retains its other tax reporting functions such as GST and FBT, these do not become the personal liability of the shareholder.

The 'disallowed amounts' refer to investments made in the last sixty days of the LTC's income year and distributed out in the sixty days after the last day; to prevent gaming of the system.

In an LAQC the profits sat in the limited liability company but the shareholders were personally liable for the income tax, but not other tax obligations, such as GST. This liability only arose if the company did not pay the income tax. Under a LTC, the profits of the company are allocated directly to the personal tax of the shareholders in proportion to their shareholding. This means that the company itself pays no tax; tax is paid by the shareholders at their marginal rate of tax. This can be a problem if the individual's rate of tax is higher than the company tax rate of 28%.

The legislation retains the original intention of the QC concept, to distribute capital gains tax free to shareholders without winding up the company.

Eight Simple Rules for being an LTC.

1. They must have five or fewer shareholders.
    - Related parties (such as husband and wife) can count as a single shareholder.
    - Companies cannot be shareholders, unless the company is an LTC.
    - The beneficiaries of trusts who have received a trust distribution in the last four years are counted as individual shareholders (unless closely related).
2. The company must be resident and registered in New Zealand.
3. Selling shares in an LTC is treated as selling the assets of the company.
    - If the market value of the company is 100k, and you sell ten per cent of your shares, this is treated on your personal income tax account as selling 10k of assets.
4. All shareholders must agree to the status. If one changes their mind, the status is lost for all.
    - If an owner seeks to change the status, from LTC to normal, this change will happen at the start of the *following* tax year.
5. An LTC can lose its status if it becomes ineligible.
    - If status is lost in this way, the change in status is backdated to the start of the *current* tax year.
6. LTC's pay no income tax as this is incurred in the name of its owners.
7. Losses claimed cannot exceed the investment made in the company.
    - 'Investments' made in the 60 days prior to the end of the tax year that are paid back sixty days into the new tax year are excluded.
8. Shareholders are not liable for the other taxes of an LTC, such as PAYE or GST.

An example:

The Spare Rib Catering Limited is an LTC established by Adam Serpent, who invested $50,000, and his friend Eve Siren, who invested nothing, but worked in the business.

Adam owns 60% and Eve the other 40%. The company was established on the 1st of January 2012.

Adam works as a horticulturist and earns $100,000 a year, and must pay tax on that of $30,000.

Eve works in the business and earns $40,000. She is taxed in the business.

In the first year, the business loses $100,000 dollars.

Those losses are split between the two shareholders.

The 2012 Year

Spare Rib Catering Company

Sales	250,000
Cost of Sales	150,000
Gross Profit	**100,000**
Expenses	**200,000**
Loss	**100,000**

Adam: $60,000 **Eve: $40,000**

Adam gets $60,000 of the loss credited to his personal tax account. However, because he only invested $50,000, he can only take fifty of this against his own taxes, balance sits in the business.

Adam Serpent 2012 Tax Return

Income	
Horticulture Supplies Ltd	100,000
Spare Rib Catering Company	-50,000
Taxable Income	**50,000**
Tax to Pay	**9,000**

If Adam had not been able to bring over the $50,000 in losses, he would have been taxed on the full 100,000 of income from Horticulture Supplies Limited.

However, if, in 2013, the Spare Rib Catering Company made a profit. Then the numbers would look like this:

The 2013 Year

Spare Rib Catering Company

Sales	600,000
Cost of Sales	200,000
Gross Profit	**400,000**
Expenses	**250,000**
Profit	**150,000**

Adam: $90,000 **Eve: $60,000**

Adam Serpent 2013 Tax Return

Income	
Horticulture Supplies Ltd	100,000
Spare Rib Catering Co: 2013	90,000
Spare Rib Catering Co: 2012 (Carried over loss)	**10,000**
Taxable Income	**180,000**
Tax to Pay	**50,000**

Adam must now pay for the tax on his share of the Spare Rib's profits, but he can claim the ten thousand back of his investment he was unable to claim in 2012.

Eve Siren's return, however, is more interesting. Spare Rib Catering made a loss in 2012, but she had made no investment so was unable to claim any of the losses and still had to pay tax on her PAYE for work done for the business. But in 2013 there was a profit to distribute. Eve Siren must pay tax on her share of this profit, but gets to deduct the unclaimed losses in the previous year.

Eve Siren 2013 Tax Return

Income	
Spare Rib Wages	40,000
Spare Rib Profit 2013	60,000
Spare Rib Losses 2012	-40,000
Taxable Income	**60,000**
Tax to Pay	**12,000**

Our mascot, Prudence, overlooking a military base on Matsu Island, Taiwan.

Limited Partnerships

Observant citizens will have noticed the emergence in the last five years of a new form of business entity; the Limited Partnership.

A few professional businesses have adopted this form, moving away from the standard partnership model. Here at Waterstone we diligently ignored this new entity until the High Court appointed us as liquidators of one; forcing us to come to grips with this hybrid beast.

A Limited Partnership is a curious construction that seems to serve no real commercial purpose except to allow for the hiding of the beneficial owners of the enterprise.

A Limited Partnership has five ingredients;

- A Partnership Agreement;
- General Partner(s)
- Limited Partners(s)
- Registration with the Registrar of Companies
- Tax

A Partnership Agreement

This is a contract between the parties. The Act details some of the matters that the Agreement must cover, including how distributions of profits are made and how partners can enter and exit the partnership. Otherwise, the parties are free to contract on whatever arrangements that they wish. The Partnership Agreement is similar in concept to the Constitution and Shareholders Agreement of a company.

A General Partner

A Limited Partnership must have at least one General Partner, but they can have more. General Partners exercise the control over the partnership in the same way that directors do. Unlike a director a General Partner is jointly and severally personally liable for the debts of the partnership.

A Limited Partner

A Limited Partnership must have at least one Limited Partner, but they can have more. Limited Partners are not liable for the debts of the business, they are similar to shareholders of companies.

A Limited Partner can become liable for the debts of a Limited Partnership only if the Limited Partner takes an active part in the management of the business and the creditor concerned believed that the Limited Partner was a General Partner.

Registration with the Registrar of Companies

There is a searchable register maintained by the by the Registrar of Companies.

The Register has details of the Limited Partnership, its listed address, the General Partners and other key details.

Details of the Limited Partners are not searchable and this is one of the key features of a Limited Partnership, the privacy for Limited Partners.

Tax

For the purposes of income tax a Limited Partnership works in a similar fashion to a Look Through Company. The Partnership is liable for its general tax obligations, such as PAYE and GST, but income tax is distributed to all partners depending on their share of the profits.

This means that partners who have different tax structures, including overseas partners, will have the gross tax obligations allocated to them.

Distinction with Companies

A Limited Partnership is a very different creature from a Limited Liability Company and the act that governs it is small, a mere 64 pages, compared to the 466 of the Companies Act, although Section 16 (that deals with liquidations) are applied to Limited Partnerships.

The Companies Act in many ways is a constitution for all companies. The Limited Partnership Act is much skinnier in part because the Partnership Agreement should cover much of that territory. Importantly, because General Partners are liable for the debts of the partnership, much of the complexity is removed.

Liquidating Trusts

Messrs Rowley and Skinner were trustees of the TPS Trust, bankrupt, and enjoying the hospitality of Her Majesty. On behalf of the TPS Trust, before their current travails, they guaranteed a debt to the BNZ.

Although the gentlemen's commercial affairs were under the control of the Official Assignee and their immediate physical needs provided by the state they remained trustees of the TPS Trust.

The bank went to court, relying on Section 17 of the Judicature Act that allowed the court to appoint liquidators to a number of bodies, including an...

"..unincorporated body of persons."

This could include a trust, the BNZ argued.

Initially the Court agreed, appointing the Official Assignee as liquidator of the TPS Trust in October last year. In December the court reversed its decision. There was an absurdity to the situation, as pointed out by the OA, that if the trustees had been one person and not two, Section 17 would not apply.

Applying a work-around, the court replaced a clearly reluctant Official Assignee as liquidator and instead appointed PWC as receivers over the assets of the trust and gave them the investigative powers that a liquidator would have enjoyed.