



Analysis & Reform

A Review of Section HK11 of the Income Tax Act 2004 and Its Effectiveness

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TABLE OF CONTENTS

I. ATTESTATION OF AUTHORSHIP	3
II. ACKNOWLEDGEMENTS.....	4
III. ABSTRACT	5
IV. INTRODUCTION	9
V. HISTORY AND PURPOSE OF SECTION HK11.....	13
VI. ANALYSIS OF SECTION HK11.....	18
A. THE LEGISLATION	18
B. SCHEME OF THE LEGISLATION.....	19
C. SPENCER V CIR (2004) 21 NZTC 18,818	20
D. CASE X11 (2005) 22 NZTC 12,175.....	21
E. AN ARRANGEMENT	24
F. EFFECT OF THE ARRANGEMENT	28
G. PURPOSE OF THE ARRANGEMENT	31
H. A DIRECTOR WOULD HAVE ANTICIPATED THAT THE COMPANY BE REQUIRED TO SATISFY A TAX LIABILITY AS A RESULT OF THE ARRANGEMENT	35
I. TAX & THE CORPORATE VEIL	51
J. SUMMARY.....	53
VII. ALTERNATE REMEDIES.....	55
A. COMMERCIAL LAW.....	55
a. <i>Separate legal personality</i>	56
b. <i>Corporate Veil</i>	57
B. COMPANIES ACT 1993.....	58
a. <i>Section 135 – Reckless Trading</i>	59
b. <i>Section 136 – Duty in Relation to Obligations</i>	61
c. <i>Section 301 – Power of Court to Require Persons to Repay Money or Return Property</i>	62
C. OTHER OPTIONS	63
a. <i>Fair Trading Act 1986 [s45 (2)]</i>	63
b. <i>Commerce Act 1986 [s90]</i>	64
VIII. OVERSEAS EXPERIENCE.....	67
A. AUSTRALIA.....	67
B. UNITED KINGDOM	69
C. CANADA	71
D. SUMMARY	74
IX. TAXATION RISK MANAGEMENT	75
A. TAX POLICY & ADMINISTRATION.....	75
B. TAX COMPLIANCE	78
C. SUGGESTED REFORM FOR SECTION HK11	80
a. <i>The Tax Avoidance Issue</i>	80
b. <i>The Active Director Issue</i>	81
c. <i>The Liquidation Issue</i>	83
d. <i>The Objection Issue</i>	84
X. SUMMARY AND CONCLUSION.....	85
XI. BIBLIOGRAPHY	89
A. BOOKS	89
B. ARTICLES.....	90
C. CASES	90
D. LEGISLATION.....	93
E. OTHER SOURCES.....	94

I. ATTESTATION OF AUTHORSHIP

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma or a university or other institution of higher learning.

Dennis Moodley

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¹ Area Manager of Inland Revenue, Manukau

III. ABSTRACT

This research refers to section HK11 in the Income Tax Act 2004 (“ITA04”). At the commencement of this research the New Zealand Income Tax Act was undergoing its final phase of a rewrite programme. The ITA04 is now Income Tax 2007, HK11² is now HD15³ and the sections name “liability for tax payable by company left with insufficient assets” is now “asset stripping of company”. Apart from these changes the actual wording of the section remains the same. The Income Tax Act 2007 came into effect on 1 April 2008.

The Commissioner of Inland Revenue (“CIR”) has the power to recover income tax owed by a company, directly from the company’s directors and shareholders. This is achieved by invoking section HK11⁴. However, for this section to be successfully invoked the CIR must prove that the company’s directors and/or shareholders entered into an arrangement with intent to deplete the company’s assets thereby leaving it unable to fully satisfy its tax liabilities.

This problem or mischief, commonly referred to as “asset stripping”, has been a long-standing conundrum for administrators, both domestically and internationally. However, overseas jurisdictions refer to this problem as ‘phoenixing’. Phoenix behaviour is an invalid transfer of assets to the detriment of creditors. Although this appears similar to asset stripping, it is not.

Asset stripping is defined⁵ as:

The practice of taking over a failing company at a low price and then selling the assets piecemeal before closing the company down.

A more common overseas reference of asset stripping is:

The process of buying an undervalued company with the intent to sell off its assets for a profit⁶

² Income Tax Act 2004

³ Income Tax Act 2007

⁴ Income Tax Act 2004

⁵ Collins English Dictionary Complete & Unabridged, New Edition

⁶ <http://www.investopedia.com/terms/a/assetstripping.asp>

But, this is not what is intended by section HK11⁷. The distinction in the New Zealand ITA04 is that although the behaviour involves disposing of company assets the focus is not on its profit but its inability thereafter to meet its tax obligations as a result of that transaction. Considering that the assets were deliberately depleted or removed, it is unlikely that the company will be able to meet its tax obligations.

A closer look at the problem however, shows that the benefit offered by the “corporate veil” or “limited liability” of companies provides certain taxpayers with the incentive for this abuse. The CIR is therefore faced with a dilemma. The CIR is statutorily bound for the care and management of the tax system. In order for the CIR to ensure the robustness of the tax system he has to maintain its integrity. The strategy adopted by the CIR to achieve this is to encourage voluntary compliance. The CIR uses a compliance triangle model to match a taxpayer’s behaviour with the best remedy.

Those who do not comply with their tax obligations are brought to account in an appropriate manner. The CIR needs to achieve this because if people see certain taxpayers being able to escape their tax obligations, the tax system will be undermined and also seen as unfair. The CIR’s dilemma is that he cannot ignore this problem. The CIR needs to reflect on:

- The optimal remedies available to target this problem/mischief?
- The most effective and efficient remedy to deter such behaviour?
- How well does this remedy stack up against international best practice?

In order for the CIR to have direct access to the person (s) behind this mischief/problem, legislators have armed the CIR with section HK11⁸. The problems with section HK 11⁹ are:

- It is entirely unsettled law i.e. there is no successful case on its application.
- Is it a tax recovery or tax assessment provision?
- Do taxpayers challenge its use against them via judicial review or the disputes process?

⁷ Income Tax Act 2004

⁸ Ibid

⁹ Ibid

But there are other remedies available to the CIR as well. The CIR is not bound to only rely on remedies available under tax legislation. The CIR being a creditor (even though an involuntary one), can make use of remedies available under other legislations – for example:

- The Companies Act 1993
- The Fair Trading Act 1986
- The Commerce Act 1986

The CIR may also consider invoking common law remedies – for example the remedy of “tracing and constructive trust” to follow assets which have been squirreled out of ailing taxpayer companies.

The CIR is a major unsecured creditor in many liquidations and sometimes is the only major unpaid creditor. Yet there is little written about the CIR’s status as creditor of an insolvent company. This however is consistent with the lack of recovery action in these types of cases by the CIR. If there were more cases where the CIR was seeking to enforce his statutory rights either under the Companies Act 1993 or ITA04, it would enhance the body of knowledge in this area.

There is also an argument that HK 11¹⁰ is a “revenue remedy” (i.e. within the Revenue legislation) whereas non-revenue remedies such as reckless trading are not within the Revenue Acts hence the reluctance of the latter by the CIR to apply non-revenue remedies. But this is not borne out by the facts. The CIR has never been inhibited with using the various provisions of the Companies Act 1993 to pursue unpaid tax liabilities.

I respectfully submit that this argument is unsound as clearly the CIR makes regular use of non-revenue remedies and is indeed required to do so – consider the prevalence of utilisation of such remedies and non-revenue law as, for example liquidation, statutory demands, the Crimes Act, District Courts Act, High Court Rules, Summary Proceedings Act, Serious Fraud Office legislation, etc.

Einstein once remarked that the very definition of insanity is “to do the same things whilst expecting different results”. This dissertation is focussed on the need for

¹⁰ Ibid

reform. The type of mindset which has created or allowed the widespread abuse of corporate entities and complex tax structures cannot deliver the CIR from his valley of troubles. This mischief requires a new approach of responding to such wilfully non-compliant taxpayers.

The view that the CIR ought to confine himself to the Revenue Acts, or automatically prefer remedies within the revenue acts is both unsound and short-sighted. The Companies Act is of pivotal importance and relevance to the CIR when dealing with corporate taxpayers. There is, in my view, no good argument against using non-revenue remedies (e.g. remedies within the Companies Act) when recovering debts from companies and delinquent directors.

The CIR ought to apply the law and legal remedies which are deemed to be most effective and appropriate in the circumstances of each case. A good reason for the CIR to use an alternate remedy is that alternative remedies might be based on more settled law compared to the jurisprudentially troubled section HK11¹¹. An example of a remedy which has more settled law in New Zealand jurisprudence is reckless trading under section 135.¹² The advantage of using this remedy was stated by Professor Gower at page 115¹³:

“...in practice this section represents a potent weapon in the hands of creditors which exercises a restraining influence on over-sanguine directors. The mere threat of proceedings under it has been known to result in the directors agreeing to make themselves personally liable for part of the company's debt. Of all the exceptions to the rule...it is probably the most serious attempt which has yet been made to protect creditors generally...from the abuses inherent in the rigid application of the corporate entity concept.”

¹¹ Ibid

¹² Companies Act 1993

¹³ Gower, *The Principles of Modern Company Law* (4th Edition)

IV. INTRODUCTION

This research explores the application of section HK11¹⁴ which is a provision that imposes liability on a company's participants (directors/shareholders) for tax payable by a company left with insufficient assets. Although the focus is an analysis on how the provision may be successful, it also seeks to understand why it is necessary for the CIR to have a statutory provision that ignores the separate legal personality of a company.

When it comes to interpreting tax legislation the courts do not approach the ITA04 with an assumption that the statute has an overall purpose to maximise tax. People who are accustomed to the doctrine of sovereignty of parliament will agree that the courts must interpret all statutes according to its true intent, meaning and spirit. But, the true intent, meaning and spirit of tax legislation is to collect tax. The courts however, seem to find this conclusion unappealing.

The general purpose of section HK11¹⁵ allows the CIR to recover tax debt from directors and shareholders of a company that has entered into an arrangement or transaction to deplete the company's assets thereby leaving the company unable to meet its tax obligations. The Revenue legislation has also made accommodation for an equivalent provision in the Goods and Services Tax Act 1985 ("GSTA"). This provision is section 61¹⁶.

However, before the CIR invokes section HK11¹⁷ as a recovery remedy certain specific requirements must be fulfilled. The major part of this research analyses these requirements. The reason for this in-depth analysis is that there has been inadequate judicial consideration on the correct interpretation and application of section HK11¹⁸. This inadequacy leaves the CIR and its legal advisors in a void/vacuum of legal uncertainty. Before considering section HK11¹⁹ it must be noted that an important initial consideration is whether the directors/shareholders have the means to pay the tax liability, otherwise there may be little point in pursuing the action.

¹⁴ Income Tax Act 2004

¹⁵ Ibid

¹⁶ Goods and Services Tax Act 1985

¹⁷ Income Tax Act 2004

¹⁸ Ibid

¹⁹ Ibid

The challenge in this research was the lack of judicial guidance on the interpretation and application of section HK11²⁰. Why is it that there is so little or no cases on the application of section HK11²¹? One possibility is that the CIR is reluctant to use this provision because it is too difficult to apply. It is difficult for the plaintiff to rely on a legal remedy as verbose and complex as section HK11²². It could also be that Revenue officers and courts prefer simpler remedies (e.g. garnishee orders).

However, traditional methods often fail to collect outstanding tax debt due to the lack of funds available in an insolvent company. Section HK11²³ therefore takes the process a step further by looking at the person in control of the company. It allows the CIR direct access to those person(s) in control of the company. If successfully invoked, section HK11²⁴ would render directors/ shareholders liable for the insolvent company's outstanding tax debt.

Tax debt is becoming increasingly difficult to collect. This is as a result of the person(s) in control of the company (directors/shareholders) pushing the boundaries of legislation. The proof in this lies in the fact that the assessment is returned but just not paid. In many corporate insolvency cases, tax debt was the only debt left which meant that the CIR was the only creditor. It must also be remembered that the CIR is an "involuntary statutory creditor". This means that the CIR cannot choose whether or not to deal with delinquent directors/shareholders. Unlike the Customs Authority, the CIR does not have possession of any assets of the debtor.

The CIR cites the reason for the increase in uncollectable debt as debt collection becoming more complex²⁵. What this means is that taxpayers are structuring their affairs in such a manner that recovery of the tax debt is becoming very difficult to collect thereby placing the revenue at risk. Complex structures involve the use of multiple entities (usually incorporated companies and trusts) in a structure which enables the taxpayer (i.e. the controlling mind) to shift assets between these entities thereby leaving creditors playing "catch up". Companies are then liquidated without the

²⁰ Ibid

²¹ Ibid

²² Ibid

²³ Ibid

²⁴ Ibid

²⁵ New Zealand Inland Revenue – Annual Report 2004, Part Three Improving Compliance

means to pay the tax debt and the person(s) in control of those liquidated companies then incorporate other entities and repeat this pattern of behaviour with new companies.

This suggests that the initial company though insolvent had resources which were transferred by some means to the successor company. A unique feature of these person(s), as previously mentioned, is that they tend to flout the law which governs the use of these entities. For example, such taxpayers on the road to insolvency and failure make unlawful distributions to shareholders.²⁶ Some might call this entrepreneurship yet if this involved a tax assessment then one would say it is tax avoidance and possibly evasion. Section HK11²⁷ with its intended effect is therefore a guardian provision of similar centrality to that of section BG1²⁸.

Part V looks at the history and purpose of section HK11²⁹. This is so that we can better understand the reason for having this section as part of our tax legislation. It will also help us later on to make recommendations for reform if need be (and I conclude that reform is indeed necessary). This section is also linked to tax and the corporate veil which explores what the courts have said about these two concepts. Part VI is an in-depth analysis of each specific requirement under section HK11³⁰. The approach adopted in this section is to predict how the courts might interpret the application of each specific requirement if a case went to court.

Part VII looks at alternate remedies to section HK11³¹. This section investigates what other, already tried and tested remedies can do for the CIR and what section HK11³² is apparently failing to accomplish. Part VIII explores what other jurisdictions do in regard to complex debt and serious non-compliance. In particular we look at Australia, United Kingdom and Canada. These jurisdictions were selected because they are Common Law jurisdictions which offer the greatest support to New Zealand's tax cases. Part IX examines the compliance issues of our tax system, in particular the "care and management"³³ duties of the CIR and the compliance model within which taxpayer

²⁶ Section 56 Companies Act 1993

²⁷ Income tax Act 2004

²⁸ Ibid

²⁹ Ibid

³⁰ Ibid

³¹ Ibid

³² Ibid

³³ "The Commissioner's duty to assess and collect taxes, and the various duties imposed under section 6 and 6A of the Tax Administration Act 1994; with particular emphasis upon the ambit and scope of

behaviour is influenced. This part concludes by offering suggestions on possible reform that will support the care and management duties of the CIR as well as help promote New Zealand's tax system as being both efficient and simple.

V. HISTORY AND PURPOSE OF SECTION HK11

Since its origins, the recovery provision has been subjected to numerous modifications to get to its current form. The provision evolved originally from section 21³⁴. This provision, as stated in the parliamentary speech given by Mr Walter Nash, was parliament's reaction to remedy the problem of companies being wound up leaving them with unpaid tax.³⁵ Parliament became aware of this problem as a result of the liquidation of Waihi and Martha Golding Mining companies. At that time, gold mining companies were taxed under special tax rules. Income Tax was only levied on the company when the company paid dividends to its shareholders.

The major concern centred on the fact that such companies, controlled by non-residents, could declare a solitary sizeable dividend and then be wound up. This left the company unable to pay its income tax liability. A new company could then be established to continue the relevant mining activities.³⁶

Section 21³⁷ then became section 276³⁸. However, this provision only covered "phoenix company" scenarios. A phoenix company has been described as:

[Where a] limited liability company fails, unable to pay its debts...At the same time afterwards, the same business rises from the ashes with the same directors, under the guise of a new limited company, but disclaiming any responsibility for the debts of the previous company.³⁹

The provision deemed a new company, which is owned and controlled by the same persons of a former company, to be an agent of that former company for all tax payable. Companies within the same group are also held liable under this provision.

In *Instant Finance Corporation (1987) v CIR*⁴⁰ Barker J stated the policy intent of the provision was:

³⁴ Finance Act 1937

³⁵ New Zealand Parliamentary debates November 2 to December 10, 1937 Col. 592

³⁶ Ibid

³⁷ Finance Act 1937

³⁸ Income Tax Act 1976

³⁹ Law Reform Committee of the Parliament of Victoria *Curbing the Phoenix company*; First report on the Law relating to Directors and Managers of Insolvent Corporations (June 1994)

⁴⁰ [1995] 17 NZTC 12,159

“...to prevent a company escaping its tax liability merely by going out of existence where the shareholders or controllers of the original company have brought a new company into existence.”

A number of cases had been decided under section 276⁴¹. In *CIR v Alistair Robb Ltd*⁴² the CIR succeeded because the Court was satisfied that the requirements under the provision were met. That is, the new company had substantially the same owners and persons in control as the former company. Furthermore, the Privy Council in *BNZ Finance Ltd v Holland (CIR)*⁴³ stated that the provision can be applied even if the CIR has consented to the dissolution of the original company. However, none of these cases addressed the policy intent or connection with company law, of section 276⁴⁴. The majority of cases did not deal with the substantive requirements of the provision. Instead they dealt with the type of tax and the status of the tax assessment of the former company.

But, this section was deficient in a number of respects. And despite practitioners concerns that section 276 appeared to have extremely broad application it nevertheless proved ineffective against asset stripping.⁴⁵ The Inland Revenue Department (“IRD”) also identified a number of deficiencies regarding the operation of the recovery provision. These concerns were recognised by the Government. The Minister of Finance at the time, Ruth Richardson stated in the Business Tax Policy Statement on 30 July 1991:

“Problems with the existing recovery provision

Section 276 is intended to enable the Commissioner to recover the tax payable by a company that has ceased to carry on a business or has been wound up (the ‘original company’), from any new company set up by shareholders of the original company

That is, it is intended to prevent schemes in which the assets of the original company are stripped out of the new company owned by the same shareholders, leaving the original company with insufficient assets to meet its tax liabilities

“Practitioners are particularly concerned about the extremely broad application of the current recovery provision. Not only does it give the Commissioner the power to recover tax from new companies which have the same directors and shareholders [of the new company] as the original company that engaged in asset stripping, but it also enables him to recover

⁴¹ Income Tax Act 1976

⁴² [1991] 13 NZTC 8,003

⁴³ [1997] 18 NZTC 13,461 (PC)

⁴⁴ Income tax Act 1976

⁴⁵ New Zealand Income Tax Law and Practice Commentary, CCH New Zealand, Auckland

the outstanding tax from other companies within the same corporate group as that original company”.⁴⁶

This means that a company in a corporate group is potentially liable for the outstanding tax arising from the asset stripping activities of any other company in that corporate group, even if they were not engaged in those activities and had little or no power to prevent those activities. It also means that companies that take over another company must be aware of any past liabilities of the company being purchased, but also of the past liabilities of all companies with substantially the same shareholders, throughout the company's entire history. In practice, many companies may find this difficult, if not impossible, to achieve.

These difficulties might arise from the fact that section 276⁴⁷ (now section HK11⁴⁸) was designed to combat a specific form of mischief – i.e. that which the CIR experienced in connection with mining companies and their liquidation dividend. Apparently section 276⁴⁹ (and section HK11⁵⁰) is not designed to effectively deal with any form of misuse of the privilege of limited liability.

“[P]ractitioners have argued that the application of section 276 should be targeted at those in control of the company at the time the taxable transactions occurred in order to ensure that the remedy for the mischief is directed at those responsible for the mischief”.⁵¹

On the 30 July 1991 the Minister of Finance stated⁵² that tax recovery section, formerly section 276⁵³, will be replaced with section HK 11⁵⁴, a “*better targeted tax recovery provision*”⁵⁵.

The new provision, section HK11⁵⁶, allows the CIR to recover a company’s tax from its directors and shareholders. This would be the case if the directors and shareholders allowed the company to enter into an arrangement or transaction whereby

⁴⁶ Business Tax Policy 1991 at pp 103, 104

⁴⁷ Income Tax Act 1976

⁴⁸ Income Tax Act 2004

⁴⁹ Income tax Act 1976

⁵⁰ Income Tax Act 2004

⁵¹ Business Tax Policy 1991 at pp 104

⁵² 1991 Budget

⁵³ Income Tax Act 1976

⁵⁴ Income Tax Act 1994

⁵⁵ Income Tax Amendment Act (No 2) 1992

⁵⁶ Income Tax Act 1994

the company's assets were depleted thereby resulting in the company's inability to fully meet its tax liabilities itself.

The significant difference between the former section 276⁵⁷ and the replacement provision is that the former provision made another related company liable for outstanding tax. The new provision makes directors and certain shareholders of the company liable for the company's tax liability if there are insufficient assets for the company to meet its tax liability itself, provided specific requirements are met. The replacement tax recovery provision enables the Commissioner to recover tax from those directors and shareholders regardless of whether they have an equity interest in another company.

The Government stated that the new provision:

“...will not be triggered by formal arrangements (under insolvency proceedings) or informal arrangements (under sec 414A of the Income Tax Act 1976) between the Commissioner of Inland Revenue, the company and its other creditors, which result in the Commissioner accepting less than the full amount of tax outstanding”.⁵⁸

Unlike the former provision, which did not specify the time at which the companies had to be related, recovery of the outstanding tax that results from these asset stripping arrangements will be sought from those taxpayers that were directors and shareholders of the company at the time the arrangement was entered into. Directors are made jointly and severally liable for the full amount of the shortfall in tax that results from action taken to strip the company of its assets.

The Government further indicated that the new provision:

“...will prevent corporates who engage in imputation credit streaming and loss trading from evading tax and eliminating their exposure to anti-avoidance legislation by stripping out the assets of their companies, and selling those companies prior to wind-up”.⁵⁹

But to enable a correct assessment it was appropriate to consider the meaning of “tax liability” in section HK11⁶⁰. However, the problem was that “tax liability was not

⁵⁷ Income Tax Act 1976

⁵⁸ Business Tax Policy 1991 at pp 105

⁵⁹ Ibid

⁶⁰ Income Tax Act 1994

defined in the Income Tax Act 1994 or any other section of the Act. The conundrum was: what was included in the tax liability? The confusion was whether tax liability constituted just the core tax or did it include a civil penalty or interest.

This problem was rectified when *The Taxation (base Maintenance and Miscellaneous) Bill 2004* was introduced on the 16 November 2004. The clause by clause analysis stated:

Clause 49 amends section HK11 to ensure that director and controlling shareholders of a company are liable for the unpaid tax (including civil penalties and use of money interest) owed by the company in the circumstance prescribed in the section.

Clause 49 was enacted as section 66 of the *Taxation (Base Maintenance and Miscellaneous Provision) Act 2005* and came into force after the Act received Royal Assent on 21 June 2005.

This was the last major modification to the content of section HK11⁶¹.

⁶¹ Income Tax Act 2004

VI. ANALYSIS OF SECTION HK11

A. The legislation

HK 11 Liability for tax payable by company left with insufficient assets

HK 11(1) [Application]

This section applies where—

- (a) any arrangement has been entered into in relation to a company; and
- (b) an effect of that arrangement is that the company is unable to satisfy under this Act a liability (called in this section the tax liability) of the company, whether arising before or after the arrangement is entered, for—
 - (i) income tax;
 - (ii) a civil penalty;
 - (iii) an amount payable under Part 7 of the Tax Administration Act 1994; and
- (c) it can reasonably be concluded that—
 - (i) a director of the company at the time of entry into the arrangement who had made all reasonable inquiries into the affairs of the company would have anticipated at that time that the tax liability would be, or would be likely to be, required to be satisfied by the company under this Act; and
 - (ii) a purpose of the arrangement was to have the effect specified in paragraph (b).

HK 11(2) [Non-application]

This section does not apply to—

- (a) any arrangement to which the Commissioner is a party; or
- (b) any arrangement to the extent that the Commissioner is satisfied that the tax liability is less than or equal to any amount of income tax—
 - (i) arising under this Act as a direct result of the performance of the arrangement; and
 - (ii) the liability for which has been duly satisfied under this Act; or
- (c) any arrangement entered into at a time when the company is under statutory management under the Reserve Bank of New Zealand Act 1989 or the Corporations (Investigation and Management) Act 1989.

HK 11(3) [Liability of directors]

Where any arrangement to which this section applies has been entered into, all persons who were directors of the company at the time the arrangement was entered into are, subject to subsection (6), jointly and severally liable for the tax liability as agent of the company.

HK 11(4) [Liability of shareholders]

Where any arrangement to which this section applies has been entered into, any person who was—

- (a) a controlling shareholder at the time the arrangement was entered into; or
- (b) a person who had a voting interest or market value interest in the company (calculated, in any case where the person is a company, as if the person were not a company) at the time the arrangement was entered into, where it could reasonably be concluded, having regard to the materiality of the benefit derived by the person from the arrangement, that the person was a party to the arrangement.—

is liable as agent of the company for—
- (c) the tax liability (excluding a civil penalty or an amount payable under Part 7 of the Tax Administration Act 1994 that is part of the tax liability) to the extent that the amount of the tax liability (so exclusive) does not exceed the greater of—
 - (i) the market value of the person's direct and indirect shareholding in the company at the time of entry into the arrangement; and
 - (ii) the value of any benefit derived by the person from the arrangement; and
- (d) that proportion of a civil penalty or an amount payable under Part 7 of the Tax Administration Act 1994 that is part of the tax liability, which is equal to the proportion which the amount for which the person is liable under paragraph (c) represents as a proportion of the tax liability (excluding the civil penalty or the amount payable under Part 7 of the Tax Administration Act 1994).

HK 11(5) [Limitation on liability]

A limitation placed on the liability of any person under subsection (4) applies notwithstanding section HK 3(3).

HK 11(6) [Circumstances where director not liable]

Notwithstanding subsection (3), a director is not liable under that subsection for any tax liability of the company where the Commissioner is satisfied that the director derived no benefit from the arrangement and either—

- (a) the director has, at the first reasonable opportunity after becoming aware of the arrangement, or of those aspects of the arrangement that render it subject to this section,—

- (i) formally recorded with the company his or her dissent in relation to the arrangement; and
- (ii) notified the Commissioner of the arrangement and of his or her dissent from that arrangement; or
- (b) the director satisfies the Commissioner that—
 - (i) the director was not at the material time or times involved in the executive management of the company; and
 - (ii) the director had no knowledge of the arrangement, or of those aspects of the arrangement that render it subject to the application of this section.

HK 11(7) [Commissioner may issue or amend assessments after company liquidated]

Subject to the time bar, but notwithstanding any other provision of this Act or the Tax Administration Act 1994, for the purposes of giving effect to this section where a company has been liquidated, the Commissioner may at any time after the liquidation make or amend any assessment of a company under this Act or an earlier Act or the Tax Administration Act 1994 in respect of any tax liability of the company as if the company had not been liquidated.

HK 11(8) [Commissioner may nominate agent]

Where the Commissioner makes or amends any assessment under subsection (7), the Commissioner must nominate 1 or more persons whom the Commissioner considers to be liable in respect of the tax liability specified in that assessment and that person or those persons are treated, for the purposes of this Act and the Inland Revenue Acts in respect of any notification or objection procedure in relation to that assessment or amended assessment, as the agent or agents of the company.

HK 11(9) [Circumstances where agent not liable]

No person is liable under this section as agent for the tax liability of a company in respect of any particular tax year where—

- (a) the company has furnished returns for that tax year before the expiry of the time allowed under section 37 of the Tax Administration Act 1994 for the furnishing of returns for the tax year in which the company is liquidated; and
- (b) the Commissioner fails to issue a notice of assessment of the company for the particular tax year before the expiry of 4 years following the end of the tax year in which the company is liquidated.

HK 11(10) [Definitions]

In this section,—

controlling shareholder means, at any time at which an arrangement to which this section applies is entered into, in respect of any company, any person whose voting interest or market value interest in that company, aggregated with the voting interest or market value interest or interests (as the case may be) of any other person or persons who are at that time associated with that person, at that time (calculated, in any case where either the person or any such associated person is a company, as if neither that person nor any such associated persons were companies and as if sections OD 3(3)(c) and (d) and OD 4(3)(c) and (d) were omitted from this Act) is equal to or greater than 50%

director means—

- (a) a person occupying the position of director by whatever name called;
- (b) in the case of an entity deemed or assumed to be a company by virtue of any provision of this Act, which entity does not have directors as such, any trustee, manager, or other person who acts in relation to that entity in the same or a similar fashion as a director would act were that entity a company incorporated in New Zealand under the Companies Act 1993.

HK 11(11) [Determination of market value and voting interests]

Except as otherwise specifically provided in this section, a person's market value interest or voting interest in a company is determined in accordance with sections OD 2 to OD 4.

B. Scheme of the legislation

Section HK 11⁶² applies if the following specific requirements are satisfied:

- An arrangement has been entered into in relation to a company;
- An effect of the arrangement is that the company is unable to satisfy a liability of the company for income tax (“the tax liability”) whether or not the tax liability exists at the time of entry into the arrangement or arises subsequently;

⁶² Income Tax Act 2004

- It can reasonably be concluded that a director of the company at the time of entry into the arrangement who had made all reasonable inquiries into the affairs of the company would have anticipated at that time that the tax liability would be required to be satisfied (or would be likely to be required to be satisfied) by the company; and
- It can reasonably be concluded that a purpose of the arrangement was that the company would be unable to satisfy a tax liability of the company.

Before considering the specific requirements further, it is appropriate to consider the approach of the courts in relation to the application of section HK11⁶³ generally.

C. Spencer v CIR (2004) 21 NZTC 18,818

The only High Court decision on section HK11⁶⁴ is *Spencer v CIR*⁶⁵ (“Spencer”) which was a Goods & Services Tax (“GST”) case in which Paterson J considered the application of section 61⁶⁶ and section HK11⁶⁷. However, in *Spencer*, the issue was whether an assessment issued to a company was valid, as the company had been struck off before the assessment was made. As a result, while this is the only High Court decision on section HK11⁶⁸, the decision in favour of the taxpayer lends no assistance to the present research because the ratio decidendi (reason for the decision) deals with tax assessment issues instead of an analysis of section HK11⁶⁹ and therefore the *Spencer* case is of very limited assistance to the issues in this dissertation.

Although there is little other case law on this provision or its predecessor, one Taxation Review Authority (“TRA”) case provides helpful guidance.

⁶³ Ibid

⁶⁴ Ibid

⁶⁵ [2004] 21 NZTC 18,818

⁶⁶ Goods and Services Tax Act 1985

⁶⁷ Income Tax Act 2004

⁶⁸ Ibid

⁶⁹ Ibid

D. Case X11 (2005) 22 NZTC 12,175

The facts

This case concerned a company (“H”) that was incorporated to borrow and on-lend money to its subsidiaries (“S”). “S” used the money to purchase commercial properties, which formed part of an investment and development project.

Due to the lender going into statutory management it called on its loans. “H” was unable to fulfil the repayment request and was then put into receivership. The lender sold some of the commercial properties under mortgagee sales. “H” reached a compromise with the lender. In exchange for a payment the lender assigned the debt to two directors Family Trusts to avoid a base price adjustment under the accruals regime. “H” claimed interest deductions and made elections to offset losses to “S”. The shares of “H” were then transferred to a third party in 1998 for a nominal consideration and the two original directors resigned.

In July 2000, the CIR issued a Notice of Proposed Adjustment (“NOPA”) to the third party proposing to disallow the deductions and transfer of losses. During the same month the company was removed from the Companies Register for failing to file an annual return. The CIR applied to the Registrar of Companies to restore the company to the register, but the third party owner objected and the CIR did not pursue the matter. In December 2000, the CIR issued NOPA’s to the two former directors advising of an intention to recover the company’s tax liability from them as agents, pursuant to section HK11. The two directors objected.

Analysis of the decision

The objection was upheld. In doing so the, Willy DCJ considered the meaning and effect of section HK11⁷⁰. In Willy DCJ’s view the application of section HK11⁷¹ is:

“... simply a case of statutory interpretation for which there exists some authoritative guidance.”

⁷⁰ Ibid

⁷¹ Ibid

Referring to the provision, Willy DCJ stated at page 12183:

“It is clear from subs. (1) that the intention of the legislature is to allow the Commissioner to recover tax from the directors and shareholders of a company which has entered into an arrangement an effect or purpose of which is to deplete or strip the company’s assets so that it is unable to meet its tax liabilities.”

Willy DCJ continued:

“There are three elements which must exist before the section applies:
[a] There must be an arrangement to which the company is a party; and
[b] An effect or purpose of the arrangement must be such that the company is not able to meet a liability for tax then existing or which arises subsequently; and
[c] It can be reasonably concluded that a director or shareholder would have been likely to anticipate that such would be the result of the arrangement and that such effect resulted.
If the Commissioner decided to invoke the section he must decide who in his view is the person liable to pay the tax and that person becomes the statutory agent of the company.”

Willy DCJ was of the view that section HK11⁷² was not a general recovery provision, but that the provision focussed on asset stripping by contributories to avoid payment of an otherwise lawful demand for income tax

At page 12,186, Willy DCJ referred to Paterson J’s dicta in *Spencer v CIR*⁷³ to highlight the importance that the company’s assets must be depleted:

“[34] The general purpose of s HK 11 of the *Income Tax Act* is to enable the Commissioner to recover tax or, in this case, GST from the directors and shareholders of a company that has entered into an arrangement or transaction to deplete the company’s assets so that it is unable to fully meet its tax liabilities.” [emphasis added by Willy DCJ]

Willy DCJ also accepted Thomas J’s dicta in *BNZ Finance Ltd v Holland*⁷⁴ that assets were stripped from the company, resulting in a benefit to the director. At page 12,186 and 12,187 Willy DCJ quotes Thomas J as follows:

“A much more sophisticated section, the new s 276 is directed at the liability of other persons for tax payable by a company which is left with insufficient assets to pay tax. Focusing on arrangements which have the effect of rendering a company unable to satisfy its liability for income tax, either the existing directors or controlling shareholders or shareholders who derive a

⁷² Ibid

⁷³ [2004] 21 NZTC 18,818

⁷⁴ [1997] 18 NZTC 13, 156

material benefit from the arrangement as parties to the arrangements may be held liable for the tax liability as agent of the company.

The amendment is clearly directed at liability for tax, whether determined or not, and cannot be construed as a 'recovery provision.' [emphasis added by Willy DCJ]

Willy DCJ then stated at page 12.187

“[Section HK11] is directed to those circumstances where a company is liquidated as part of an arrangement the effect of which is to render the company unable to pay the tax assessed. That can only mean that there is something about the arrangement which produces this result. That something must involve depleting the assets of the company. If it did not then to the extent the company has assets on liquidation they would be available to meet any lawful tax liability”.

At page 12,187, Willy DCJ concluded that, for section HK11⁷⁵ to become available to the CIR, there must be an allegation that there was an arrangement, which had an effect of depleting the assets of the company, with the result that it is unable to pay its tax liability and further that the company lacks the assets to meet its tax liabilities.

In summary, *Case XII*⁷⁶ provided the following guidance for the application of section HK11⁷⁷:

- there must be an arrangement to which the company is party,
- a purpose or effect of the arrangement or transaction must be that the company's assets are depleted so that it is unable to fully meet its existing tax liabilities or those that rise subsequently,
- the Commissioner must decide who in his view is the person liable to pay the tax and that person becomes the statutory agent of the company,
- a director who derives no benefit from the arrangement cannot be liable, and
- it must be reasonably concluded that the director would have been likely to anticipate that result of the arrangement and that such effect resulted.

As Willy DCJ stated, this is not a developing area of legal policy, but a case of statutory interpretation. Each specific requirement for the application of section HK11⁷⁸ will now be considered

⁷⁵ Income Tax Act 2004

⁷⁶ [2005] 22 NZTC 12,175

⁷⁷ Ibid

⁷⁸ Ibid

E. An arrangement

Although the requirement of whether an arrangement had been entered into in relation to a company seems to be listed as a “stand alone” requirement in section HK 11⁷⁹ it is impossible to apply it in isolation. It begs the question: - an arrangement to do what?

This question can be answered by looking at the second requirement of the section. That is, was there an arrangement that caused or had an effect that the company was unable to satisfy a tax liability? Therefore, to ascertain whether there was an arrangement you must look at all transactions that result in the company not being able to pay a tax liability and then decide whether those transactions amount to an “arrangement” within the meaning of the definition of the term.

“Arrangement” is defined as⁸⁰:

“Arrangement” means any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect:

There are no decided cases on the meaning of an arrangement in the context of section HK 11⁸¹. There are however various decisions on the meaning of the term in the context of tax avoidance, section BG1⁸². The leading decision on what is an arrangement is *Newton v FCT*⁸³. In that case, Lord Denning stated at page 764:

“... the word "arrangement" is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons--a plan arranged between them which may not be enforceable at law. ...not only the initial plan, but also all the transactions by which it is carried into effect..”

The definition of arrangement by Lord Denning in *Newton v FCT*⁸⁴ was followed by *Elmiger v CIR*⁸⁵ and given endorsement by Richardson P in *CIR v BNZ Investments*⁸⁶ where he stated at page 465:

⁷⁹ Ibid

⁸⁰ Section OB1 Income tax Act 2004

⁸¹ Income Tax Act 2004

⁸² Ibid

⁸³ [1958] AC 450

⁸⁴ Ibid

⁸⁵ [1966] NZLR 683

⁸⁶ [2002] 1 NZLR 450

‘The definition of arrangement closely follows the meaning given to the composite expression ‘contract agreement or arrangement’ in *Newton...*’

From the words of Lord Denning, two further concepts emerge that require analysis.

They are:

1. Contract or agreement;
2. Plan or understanding

1. Contract or agreement

In *Newton v FCT*⁸⁷ Lord Denning was of the opinion that “contract” is a technical word and implies an agreement enforceable by law. Contract is therefore used in its ordinary sense and refers to transactions containing:

- An offer;
- Acceptance;
- Intention to create legal obligations; and
- Consideration

Both “contract” and “arrangement” appear to be used synonymously. In other words they are both enforceable at law.

2. Plan or understanding

In *Newton v FCT*⁸⁸ Lord Denning’s delivery said of the term:

“But it must in this section comprehend, not only the initial plan, but also all the transactions by which it is carried into effect – all transactions, that is, which have the effect of avoiding taxation”

From this statement, it is concluded that the concept of plan or understanding has two elements: - a physical and mental element. The physical element comprises:

⁸⁷ [1958] AC 450

⁸⁸ *Ibid*

1. An initial plan
2. All the necessary steps in order to execute the plan
3. The result.

The mental element is the awareness of the taxpayer of the initial plan and a willingness to be party to it and undertaking the steps in order to achieve the result.

In *Elmiger v CIR*⁸⁹ after Woodhouse J accepted that the principles established in *Newton v FCT*⁹⁰ were applicable to New Zealand, he made the following comment:

“There clearly was an overall plan preceding the individual steps, and equally the intention was that those steps should take effect as a whole.”

In *Tayles v CIR*⁹¹, the scope of “an arrangement” was described as something that is not limited to a single document or transaction. Rather, it is necessary to consider all relevant dealings or set of circumstances between the parties, in order to establish the scope of the arrangement.

The Privy Council in *CIR v Europa Oil (No. 1)*⁹² put it this way at page 651:

“The documents therefore , in their Lordships opinion, point unequivocally towards an interdependence of obligations and benefits under a complex of contracts which, though embodied in separate documents represents on contractual whole ... - that the contractual arrangements were interdependent, one on the other.”

Arrangement is a complex term and as interpreted by the courts includes the formulation of a plan, the execution of that plan in an arranged way and the result. The steps are inclusive in identifying the existence of an arrangement. This definition of “arrangement” is very broad comprising all steps by which it is carried into effect. In *CIR v BNZ Investments Limited*⁹³, the majority of the Court of Appeal considered that

⁸⁹ [1966] NZLR 683

⁹⁰ [1958] AC 450

⁹¹ [1982] 5 NZTC 61,311

⁹² [1971] NZLR 641

⁹³ [2002] 1 NZLR 450

that an arrangement cannot exist in a vacuum and that the definition of arrangement presupposes there are two or more participants who arrive at an understanding. Richardson P stated:

“In short an arrangement involves a consensus, a meeting of minds between parties involving an expectation on the part of each that the other will act in a particular way.

...

The essential thread is mutuality as to content. The meeting of minds embodies an expectation as to future conduct. There is consensus as to what is to be done.

...

A commercially realistic approach should be adopted when assessing the extent of the meeting of minds, particularly in cases where a significant feature of the arrangement is obtaining and sometimes the sharing, of tax benefits. Where that feature is present, a court is unlikely to find persuasive the stance of a taxpayer who professes to have no knowledge or expectation of the mechanism by which the benefit was to be delivered. In such a situation the taxpayer may well appropriately be regarded as having authorised or accepted whatever mechanism was actually used. In such circumstances a consensus could properly be found in respect of the use of that mechanism”.

Therefore an arrangement requires a meeting of minds between at least two parties. That means section HK11⁹⁴ could not be invoked against a single person working on his own. Furthermore, by analogy, section HK 11⁹⁵ must encompass the entire dimension that amounts to having the effect that a company is unable to pay its tax.

However, the law on what constitutes an arrangement has been further developed. In a later Privy Council case, *Peterson v CIR*⁹⁶ Lord Millet rejected the need for a meeting of minds between the parties noting also that the taxpayer in question need not be party to the arrangements or be privy to its details. Lord Millet said at paragraph 34:

“...Their Lordships do not consider that the “arrangement” requires a consensus or meeting of minds; the taxpayer need not be a party to “the arrangements” and in their view he need not be privy to its details either”.

This decision provides useful guidance to the application of section HK11⁹⁷. If a person does not need to be party to an arrangement for tax avoidance purposes, then

⁹⁴ Income Tax Act 2004

⁹⁵ Income Tax Act 2004

⁹⁶ [2005] 22 NZTC 19,098

⁹⁷ Income Tax Act 2004

under section HK11⁹⁸ the company and those liable may also not be required to be party to the arrangement that has the effect of the company not being able to satisfy its tax liability.

It may also mean that a director who has no knowledge of the arrangement may still be liable under section HK11⁹⁹ unless they meet the circumstances in which the director will not be held liable. However, the potential of extending the ambit of section HK11 based on the *Peterson v CIR*¹⁰⁰ decision is inconsistent with the policy intent of the provision. It is creating a higher duty of care for a director which means that they would have to be more involved in the daily business of a company if they are to protect themselves fully against a claim under section HK11¹⁰¹. Strangely though, the court said in *Peterson v CIR*¹⁰² that one can look at part of an arrangement. *Petersen v CIR*¹⁰³ is probably wrong. This places an important focus on the much anticipated upcoming Supreme Court decision of *Accent Management Ltd v CIR*¹⁰⁴.

F. Effect of the Arrangement

Having considered an arrangement, it is appropriate to consider whether “an effect of the arrangement” left the company unable to satisfy its tax liability. In the court of Court of Appeal decision of *Tayles v CIR*¹⁰⁵ at page 61,318 Mullen J cited with approval the Privy Council decision in *Newton v FCT*¹⁰⁶ and *Ashton v CIR*¹⁰⁷:

“Whatever difference of meaning there may be in dictionary terms between the words "purpose" or "effect", posed as they seem to be as alternatives in sec. 108, they usually have been looked on in the cases as a composite term. "The word `purpose' means not motive but the effect which it is sought to achieve — the end in view. The word `effect' means accomplished or achieved. The whole set of words denotes concerted action to an end — the end of avoiding tax." *Newton v. F.C. of T.* at p. 465. And "if an arrangement has a particular purpose, then that will be its intended effect. If it has a particular effect, then that will be its purpose" *Ashton v. C. of I.R.* at p. 61,034”.

⁹⁸ Ibid

⁹⁹ Ibid

¹⁰⁰ [2005] 22 NZTC 19,098

¹⁰¹ Income Tax Act 2004

¹⁰² [2005] 22 NZTC 19,098

¹⁰³ Ibid

¹⁰⁴ [2005] 22 NZTC 19,027

¹⁰⁵ [1982] 5 NZTC 61,311

¹⁰⁶ [1958] AC 450

¹⁰⁷ [1975] 2 NZTC 61,030

Lord Denning in *Newton v FCT*¹⁰⁸ stated at page 764

“In applying the section you must, by the very words of it, look at the arrangement itself and see which is its effect - which it does – irrespective of the motives of the person who made it”.

It is clear that the motives of the parties are irrelevant in determining the “effect of an arrangement” and that it is necessary to objectively consider the arrangement itself, to determine what the arrangement does. This will be the “effect of the arrangement”.

This objective test, having regard to the arrangement, is supported by the High Court and the Court of Appeal decisions in *Auckland Harbour Board v CIR*¹⁰⁹. Although this case considered the anti-avoidance provision in the accrual regime, it is nonetheless a useful. This case considered the meaning of the words “effect of defeating the intent and application of” the accrual rules. Potter J, in the High Court determined that the word “effect” had the meaning “*the result or consequence of an action*”. He pointed out that the test was an objective one having regard to the transaction. Potter J concluded that the arrangement did have the effect of defeating the intent and application of the accrual rules.

The decision of Potter J was however, overturned on appeal. The Court of Appeal differed from the High Court in the manner in which they interpreted the intended effect of the accrual regime and the manner in which they determined what the “effect” of the arrangement was. The Court of Appeal considered that Potter J erred, because her honour sought to compare what actually happened with what would have happened. Richardson P, delivering the majority decision, stated as page 15,451:

“In context, we consider it [“effect”] has its standard meaning of “the end accomplished or achieved”

The Court of Appeal considered that it was important to focus the enquiry on what actually took place and not on other possible transactions that the taxpayers could have undertaken. Therefore, in order to determine the “effect” of an arrangement, it is necessary to have regard to what the arrangement itself does. Thus the effect of the

¹⁰⁸ [1958] AC 450

¹⁰⁹ [1998] 18 NZTC 13,826 (HC); [1999] 19 NZTC 15,433

arrangement is the end accomplished or achieved. This meaning of ‘effect’ is consistent with the dissenting view of Thomas J in the Court of Appeal decision of *CIR v BNZ Investments Limited*¹¹⁰ wherein he stated at page 17,132:

The word “effect directs the focus to the result or consequence of the arrangement...It focuses on the physical characteristics of the arrangement...It is sufficient to refer to the succinct statement of Woodhouse P in the *Challenge Corporation* case (at p 533): “I am satisfied as well that the issue..is something to be decided, no subjectively in terms of motive, but objectively by reference to the arrangement itself.”

The word “effect”, in the context of section HK11¹¹¹ should therefore be interpreted similarly. It is an objective test having regard to the outcome or outcomes of the arrangement. It is worth noting however that section HK11¹¹² uses “an” with the noun “effect”. This implies that there may be more than one effect. Furthermore the section refers to any one effect of the arrangement. Therefore, an “effects” prominence or incidental nature is irrelevant.

The use of “an” can be contrasted to the use of “the”. In other words, had the section been written as “the effect”, this would have suggested that the effect was possibly the only effect or at least a dominant or over-riding effect. This is not the case in section HK11¹¹³. Hence, “an effect” is merely one result or consequence or end accomplished or achieved of the arrangement and may be, then, merely incidental.

So, one result or consequence or end accomplished or achieved of the arrangement must be that the company is unable to satisfy a liability for tax. On the plain words of the section an effect of the arrangement is that the company is unable to satisfy a tax liability. The ordinary meaning of “unable” is “lacking the skill, means, or opportunity to do something”¹¹⁴. This combined with the fact that it must be an effect of the arrangement, suggests that the section was aimed at situations whereby prior to the arrangement, the company was able to satisfy a liability for tax, but an arrangement was entered into in relation to the company and an effect of that arrangement was that the company was now unable to satisfy the liability for tax.

¹¹⁰ [2001] 20 NZTC 17,103

¹¹¹ Income Tax Act 2004

¹¹² Ibid

¹¹³ Ibid

¹¹⁴ Concise English Oxford Dictionary (10th ed revised 2001)

Therefore, the word ‘unable’ connotes an absolute requirement, in that the company is either able or unable to satisfy its tax liability. The section requires that an effect of the arrangement be that the company is either able or unable to satisfy its tax liability. If the company was unable to do this prior to the arrangement whether the company became less able after the arrangement is irrelevant. Section HK11¹¹⁵ cannot be invoked in this situation.

There is no degree of inability either because it is considered that an effect of the arrangement will not make the company ‘unable’. The inference is that there was no intention that a degree of inability was a consideration for the application of section HK11¹¹⁶.

However, section HK11¹¹⁷ does not refer specifically to the nature of the arrangement. The section requires that an effect of the arrangement is that the company is unable to satisfy a tax liability, whether existing at the time of entry into the arrangement or arising subsequently. Such an arrangement could be where the arrangement has the effect of depleting the assets of the company and, therefore, its ability to meet that tax liability.

On the basis of the words of the section, the history and the purpose of the legislation, it is concluded that the section is intended to catch arrangements by which a company is unable to meet a likely tax liability, such as where assets are knowingly depleted to this effect. It is not that the arrangement is to avoid paying tax. It is that an effect of the arrangement is that the company cannot pay its tax liability.

G. Purpose of the Arrangement

“Purpose” is defined as:

“the reason for which something is done or for which something exists”¹¹⁸.

The courts have considered the meaning of “purpose” in a number of cases.

¹¹⁵ Income tax Act 2004

¹¹⁶ Ibid

¹¹⁷ Ibid

¹¹⁸ Concise English Oxford Dictionary (10th ed revised 2001)

In *CIR v BNZ Investment Advisory Services Ltd*¹¹⁹ Doogue J said at 11,115:

“The parties spent some time in their submissions in respect of the meaning of the words “principle purpose”. So far as the word “purpose” is concerned, there was no real difference between them in their submissions...They were agreed that purpose is the object which the taxpayer has in mind or in view. It is not synonymous with intention or motive”.

In *Wairakei Court Ltd v CIR*¹²⁰ at page 15,206 Chisholm J stated:

“Purpose is a reference to the object that the taxpayer had in mind or in view. This is not synonymous with intention or motive. Moreover, care must be taken to avoid confusing the means by which the taxpayer achieves its purpose with purpose itself”.

The Court of Appeal in *CIR v Wellington Regional Stadium Trust*¹²¹ stated at page 19,461:

“The distinction between intention and purpose is thus important in the income tax context, as well as in a number of other contexts, including GST and competition law”.

Therefore, “purpose’ is a reference to the object that the taxpayer had in mind and this is distinct from “intention” and ‘motive”. There is also a distinction between the means by which a purpose is achieved and the purpose itself. Having established what is understood by “purpose” it is appropriate to consider the test of purpose.

The Court of Appeal in *CIR v National Distributor Ltd*¹²² considered “purpose” in the context of the Income Tax Act 1976. In particular, the sale or disposition of any personal property if, acquired for the purpose of selling or disposing of it. Richardson J (as he was then) stated at page 6,350:

“It is well settled that the test of purpose is subjective requiring consideration of the state of mind of the purchaser as at the time of acquisition of the property. Where the taxpayer is a company it is the collective purpose in the minds of those in control of those decisions of the company which is determinative”.

¹¹⁹ [1994] 16 NZTC 11,111

¹²⁰ [1999] 19 NZTC 15,202

¹²¹ [2005] 22 NZTC 19,445

¹²² [1989] 11 NZTC 6,346

Richardson P and Henry J reiterated this test in the Court of Appeal case of *CIR v National Insurance Co of New Zealand Ltd*¹²³. It has also been used in a number of High Court decisions including *King v CIR*¹²⁴ and *Wellington Regional Stadium Trust v CIR*¹²⁵.

However, Richardson P's subjective test was to test the purpose of a person. In contrast, "purpose" in section HK11¹²⁶ is in relation to an arrangement. The phrase is "a purpose of the arrangement". Therefore, it is appropriate to consider whether the test for "purpose" in relation to an arrangement is the same.

It is noted that the purpose of an arrangement is also relevant for the application of shortfall penalties¹²⁷. In that context, the meaning of purpose of an arrangement has been considered by the courts. However, it is acknowledged that section 141D¹²⁸ refers to a "dominant" purpose of the arrangement. In contrast, section HK11¹²⁹ refers merely to "a purpose of the arrangement". Despite the additional criteria of "dominant" in section 141D¹³⁰, it is concluded that this does not negate the relevance of the view taken by the courts on the appropriate meaning given to the purpose of the arrangement.

In relation to the dominant purpose of an arrangement in section 141D¹³¹, Venning J in the High Court decision, *Accent Management Ltd v CIR*¹³² said at paragraphs 367 to 369:

"Mr Stewart [council for the plaintiffs] emphasised the need for the Court to make a finding of dominant purpose. He submitted that Ronald Young J was incorrect in *Erris Promotions* to suggest the dominant purpose relates to the arrangement itself. He submitted that the better view was it is the purpose of the taxpayer to which the section is directed.

In *Erris Promotions v CIR* (2003) 21 NZTC 18,330 Ronald Young J said at paragraph 374:

"...viewed objectively, the position of the taxpayer must be as a consequence of an arrangement that is entered into which has as its dominant purpose tax avoidance. And so I must consider if the dominant purpose of the joint venture, viewed objectively, was tax avoidance. Here

¹²³ [1999] 19 NZTC 15,135

¹²⁴ [2006] 22 NZTC 19,691

¹²⁵ [2004] 21 NZTC 18,648

¹²⁶ Income Tax Act 2004

¹²⁷ Section 141D, Tax Administration Act 1994

¹²⁸ Tax Administration Act 1994

¹²⁹ Income tax Act 2004

¹³⁰ Tax Administration Act 1994

¹³¹ Ibid

¹³² [2005] 22 NZTC 19,027

s 141D (7) (b) (i) is concerned not with the taxpayers intent or knowledge but with whether their claim for depreciation losses arose as a consequence from a scheme which had as its dominant purpose tax avoidance.”

I agree with Ronald Young J’s approach. The only matter that can be viewed objectively...is whether the arrangement was entered with a dominant purpose of avoiding tax. The purpose of the section is to penalise those taxpayers who...have entered into...arrangements...with a dominant purpose of taking...tax positions that reduce or remove tax liabilities or give tax benefits” as set out in subs 141D (1) is not met if the objective test is to be applied only to whether the taxpayer took a tax position in respect or as a consequence of an arrangement. The objective test applies to the assessment of dominant purpose”.

Ronald Young J, in *Erris Promotions v CIR*¹³³ considered that it was not the taxpayer’s intent or knowledge that was relevant but the purpose of the arrangement into which the taxpayer entered. Venning J, in *Accent Management Ltd v CIR*¹³⁴ agreed with this approach by Ronald Young J and concluded that the section related to arrangements with a dominant purpose and that an objective test applies to the assessment of a dominant purpose. Venning J continued by contrasting the taxpayer’s “general interest” (a subjective test), with the requirement to view “objectively the dominant purpose of the arrangement”.

The courts have differentiated between the purpose of the taxpayer and the purpose of an arrangement. For the former the test is subjective, but for the purpose of an arrangement the test is objective. The purpose of an arrangement does not relate to the taxpayer’s intent or knowledge in entering into the arrangement. The purpose of an arrangement is determined by an objective assessment.

In the words of section HK11¹³⁵, although the company entered into an arrangement through an agency, being the directors, the purpose of the arrangement is not found by considering the state of mind of the agents. The test of purpose in the context of section HK11¹³⁶ is objective, as stated by Venning J in *Accent Management Ltd v CIR*¹³⁷. Therefore, whether a purpose of the arrangement was to have the effect of depleting the assets of the company so that the company is unable to satisfy the tax liability requires an objective consideration of the *reason* for the arrangement and whether the object was that the company would be unable to satisfy a tax liability.

¹³³ [2003] 21 NZTC 18,330

¹³⁴ [2005] 22 NZTC 19,027

¹³⁵ Income Tax Act 2004

¹³⁶ Ibid

¹³⁷ [2005] 22 NZTC 19,027

Having considered the meaning of purpose, it is relevant to note that section HK11¹³⁸ uses the phrase “a purpose of the arrangement”. Accordingly, if any purpose of the arrangement was to have the effect of depleting the assets of the company, that purpose is sufficient. It is not necessary that the purpose be a dominant or principle purpose. Therefore, section HK11¹³⁹ applies where it can be reasonably concluded that a purpose of the arrangement, which viewed objectively, was to have the effect that the company would be unable to satisfy a tax liability.

H. A director would have anticipated that the company be required to satisfy a tax liability as a result of the arrangement

The provision¹⁴⁰ contains a specific definition of director.

director means—

- (a) a person occupying the position of director by whatever name called;
- (b) in the case of an entity deemed or assumed to be a company by virtue of any provision of this Act, which entity does not have directors as such, any trustee, manager, or other person who acts in relation to that entity in the same or a similar fashion as a director would act were that entity a company incorporated in New Zealand under the Companies Act 1993.

By reference to the Companies Act 1993 in the definition its implication is that the definition and duties of a director as specified in the Companies Act 1993 apply equally to section HK11¹⁴¹. The director of a company includes “de facto directors”, “shadow directors” and “deemed directors”¹⁴².

Furthermore, the person must occupy the position of director even though they may not be specifically referred to as a director. Evidence to support this would be found in the way the person (s) acted combined with their responsibilities, activities and decision making powers. In *Mistmorn Pty Ltd (in Liq.) v Michael Yasseen*¹⁴³, Mr Yasseen was held to be a director as the Court believed he undertook obligations that indicated he was a director, even though his wife was the only appointed director of the

¹³⁸ Income Tax Act 2004

¹³⁹ Ibid

¹⁴⁰ Section HK11(10) Income Tax Act 2004

¹⁴¹ Income Tax Act 2004

¹⁴² A “de facto” director is someone who may not have been appointed as a director but who acts in the same way as a director or is held out as such. A “shadow director” is someone in accordance with whose directions or instructions the directors of the company are accustomed to act. It will thus cover the “puppet master” who, for whatever reason, does not wish to appear on the face of the record as a director of the company but who in fact “pulls the strings” and tells the directors what to do. This would also include parent companies who in effect decide what their subsidiaries do.

¹⁴³ [1996] 14 ACLC 1,387

liquidated company. Mr Yasseen's duties included negotiating leases on behalf of the company; arranging the fit out of the business premises and arranging the opening of the business by the mayor and speaking at the opening when his wife was present.

The definition also extends to an entity that is not a company, such as a trust or unincorporated society and extends the same treatment to persons who act in a similar fashion as a director as if that entity was a company. Therefore trustees of a trust may also be potentially liable under section HK 11¹⁴⁴. However, thus far, the CIR has not sought to bring such an action against any trustees of a trust that is unable to satisfy its tax liability.

Furthermore, section HK11¹⁴⁵ refers to a hypothetical director. The reference is to a director, at the relevant time, who made all reasonable inquiries into the affairs of the company. The director would then have anticipated at that time the tax liabilities to be satisfied by the company. This is part of the test to determine whether section HK11¹⁴⁶ applies. The test is an objective one. It also follows that where the facts relate to a sole director of a company, as opposed to a company having a board of directors, the test relates to a hypothetical sole director at the time of entry into the arrangement.

There are a number of requirements to consider for the application of this part of the provision. These are:

- The time when it is necessary that a director would have anticipated the company's tax liability or the likelihood of such liability;
- The meaning of "reasonable"; and
- Whether a director having made those inquiries, would have anticipated at the time of entry into the arrangement that the tax liability would be or likely to be required to be satisfied by the company.

1. The time

Firstly, it relates to the identification of the hypothetical director. The section refers to "*a director of the company at the time of entry into the arrangement*". In this

¹⁴⁴ Income Tax Act 2004

¹⁴⁵ Ibid

¹⁴⁶ Ibid

instance, there is an express reference to the relevant time being, “*at the time of entry into the arrangement*”. So the section only applies to a person who is a director at the time of entry into the arrangement.

Secondly, it relates to the time at which reasonable inquiries were made. The section states that “*a director...who made all reasonable inquiries into the affairs of the company*”. In this instance, there is no express reference to the timing of those inquiries, so it is appropriate to consider the section as a whole to determine the intended timing of this component.

Thirdly, it relates to the anticipation of the tax liability and the time at which it can be reasonably concluded that the tax liability could be anticipated. The section states “*a director...would have anticipated at that time that the tax liability would be or would be likely to be, required to be satisfied by the Company under this Act*”. The relevant and express timing words are “*at that time*”. This can only refer to the time of entry into the arrangement.

This is the express time stated in relation to the identification of the hypothetical director. Therefore, when the section is considered as a whole, it is clear that a single time is relevant for each of the components. The timing for each is the time of entry into the arrangement. Accordingly, it is considered that the section is required to be applied based on the circumstances that existed at the time of entry into the arrangement. This means that circumstances that would only be discovered by making inquiries subsequent to the time of entry into the arrangement will not be relevant, given the statutory wording.

2. Meaning of “reasonable”

Reasonableness is an objective standard to be concluded from the facts of a particular case. Therefore, what are “*reasonable inquiries into the affairs of the company*” will vary with every factual situation.

This is consistent with the approach of the High Court in *Vinyl Processors (New Zealand) Ltd v Cant*¹⁴⁷. Hillyer J held that the word “reasonable” imported an objective test of reasonableness and the existence of “reasonable grounds” must be tested by the standard of an officer of the company of reasonable competence.

Vinyl Processors concerned the liability of the directors of the company for the company’s debts. Although the directors knew that the company was making losses, they continued to trade for a further year, and thereby substantially increased the company’s losses, before a receiver and liquidator were ultimately appointed. The liquidator brought proceedings against the directors under section 320 (1) of the Companies Act 1955, which empowers the Court to make such a declaration if, in the course of the winding up of a company, it appears amongst other things that:

- (a) Any person was, while an officer of the company, knowingly a party to the contracting of a debt by the company and did not, at the time the debt was contracted, honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts, (including future and contingent debts);

The Court held that the word reasonable in section 320 (1) (a)¹⁴⁸ imports an objective test and must be tested by the standard of an officer of the company of reasonable competence. Offences under section 320 (1) (a)¹⁴⁹(now section 135 to 137¹⁵⁰) are knowledge offences concerning the directors’ conduct. Section 135¹⁵¹, in looking whether the conduct is “*likely to create a substantial risk*” to creditors, is similar to section HK11¹⁵², which considers whether the directors should have anticipated that a tax liability ‘*would be likely to be required to be satisfied*’.

Therefore, it is considered that the terms “*reasonably be concluded*” and “*all reasonable inquiries*” used in section HK11¹⁵³ imply an objective test as to whether a director of reasonable competence is likely to have reached that conclusion based on reasonable inquiries and concluded from the facts.

¹⁴⁷ [1991] 2 NZLR 416

¹⁴⁸ Companies Act 1955

¹⁴⁹ Ibid

¹⁵⁰ Companies Act 1993

¹⁵¹ Ibid

¹⁵² Income Tax Act 2004

¹⁵³ Ibid

3. Anticipated the tax liability to be satisfied

“*Anticipate*” is defined¹⁵⁴ as meaning “to expect”. In the present discussion this meaning will be used. Using this meaning of “*anticipate*”, a requirement for section HK11¹⁵⁵ to apply is that it can be concluded on an objective basis that at the time of entry into the arrangement, a director would have to expect that the company would have a tax liability to be satisfied.

The term “*likely*” as used in section HK11¹⁵⁶ is also not defined in the Income Tax Act. However, the most relevant definition¹⁵⁷ of the term is as follows:

Likely - probable; that looks as if it would happen; to be reasonably expected.

In *Commissioner of Police v Ombudsman*¹⁵⁸ the High Court considered the term “*would be likely*”, as used in section 6(c)¹⁵⁹. Jefferies J held stated at page 589 that:

“The words “*would be likely*” I consider mean that there is a distinct, or significant possibility that the result might occur, but no higher than that. On the scale of probability it is above a slight chance and below an expectation”.

Accordingly the phrase “*would be likely to be*” refers to a tax liability that can reasonably be expected to arise with some degree of certainty. Therefore, it can then be concluded that section HK11¹⁶⁰ requires that a hypothetical director at the time of entry into the arrangement who made all reasonable inquiries into the affairs of the company would regard as probable, at that time, that the tax liability would be required to be satisfied

The above analysis is considered when section HK11¹⁶¹ applies. However, part of section HK11¹⁶² also sets out its consequences. It is therefore appropriate to consider the provision’s reference to “tax liability” and “benefit”

¹⁵⁴ Collins English Dictionary-complete and unabridged (7th Edition, 2005)

¹⁵⁵ Income Tax Act 2004

¹⁵⁶ Ibid

¹⁵⁷ The New Shorter Oxford dictionary on Historical Principles (5th Edition 2002)

¹⁵⁸ [1985] 1 NZLR 578

¹⁵⁹ The Official Information Act 1982

¹⁶⁰ Income Tax Act 2004

¹⁶¹ Ibid

¹⁶² Ibid

4. “Tax liability” and “benefit”

If the conditions in section HK 11¹⁶³ are satisfied all directors of the company at the time the arrangement was entered into are jointly and severally liable for the tax liability as agents of the company¹⁶⁴. Directors will not be liable if the CIR is satisfied that they derived no benefit from the arrangement and they have either dissented from the arrangement and notified the CIR accordingly or have not participated in the decision to enter into the arrangement¹⁶⁵.

The shareholders of the company on the other hand are liable if at the time the arrangement was entered into they are either:

- controlling shareholders; or
- they have a voting interest or market value interest in the company and it can reasonably be concluded that (having regard to the materiality of the benefit derived by the shareholders from the arrangement) they were parties to the arrangement.

The shareholders are then liable for:

- the tax liability of the company to the extent of the greater of the market value of their direct and indirect shareholding in the company at the time the arrangement was made¹⁶⁶; and
- the proportion of the late payment penalty or interest comprising part of the tax liability, which reflects the proportion of the tax liability for which they are liable¹⁶⁷.

But, the liability of shareholders is limited. Shareholders are liable up to a maximum amount of the core income tax. The core tax being the company’s tax liability excluding late payment penalties and interest for late payment. The maximum amount of the core income tax for which a shareholder is liable cannot exceed an amount equal to the greater of:

¹⁶³ Ibid

¹⁶⁴ Section HK11(3) Income tax Act 2004

¹⁶⁵ Section HK11(6) Income tax Act 2004

¹⁶⁶ Section HK11 (4)(c) Income Tax Act 2004

¹⁶⁷ Section HK11 (4)(d) Income Tax Act 2004

- the market value of the shareholder’s direct and indirect interest in the company at the time of the arrangement; and
- the value of any benefit derived from the shareholder under the arrangement.

The meaning of “joint and several liability” was explained in *Grunwald v Hughes*¹⁶⁸ in the following terms:

“Perhaps the best account of the meaning of a conclusion for joint and several liability is that given by Lord McLaren in *Fleming v Gemmill* [1908] SC 340 at page 345, 15 SLT 691, at page 693, where he said:

the word ‘several’ implies that against whatever number of defenders a man proceeds, each is liable for the whole sum sued for, and the word ‘jointly’ or ‘conjunctly’ secures to those against whom the decree is made operative the right of rateable relief against the persons who have not paid”.

That description shows that the essential of the joint and several liability is that each defender should be liable for the whole damage. (p. 214-215)”

Therefore, the entire amount of the company’s tax liability may be recovered from any of the directors but each of the directors has a right to recover a contribution from other directors. However, the liability of shareholders in respect of core tax is limited to the greater of the market value of their direct and indirect interest in the company at the time the arrangement was entered into together with a proportion of the late payment penalty and interest based on the proportion of the core tax for which they are liable.

There appears to be no policy reason for shareholders being liable for interest and any late payment penalty while the directors are not liable. A director is potentially liable for a greater amount than a shareholder as shareholders are liable only for a proportion of core income tax and a proportion of the interest and late payment penalties on the income tax but apportionment is not required to establish the liability of directors. Directors are jointly and severally liable for the company’s tax liability.

The business and affairs of the company must be managed by or under the control of the directors and the directors have all the powers necessary for managing the company and supervising and directing its management¹⁶⁹. In some circumstances a shareholder is deemed to be a director, including where the company’s constitution

¹⁶⁸ [1965] SLT 209

¹⁶⁹ Section 128 Companies Act 1993

confers a power on shareholders which would otherwise fall to be exercised by the board of directors¹⁷⁰.

A director for the purpose of section HK 11¹⁷¹ is a person who occupies the position of director “by whatever name called”¹⁷². However, a director who has not derived a benefit from the arrangement or transaction and who has not participated in the decision to enter into the arrangement will not be liable¹⁷³.

One of the conditions for the application of section HK 11¹⁷⁴ is that it can reasonably be concluded that a director should have anticipated that the company would be required to satisfy a tax liability. Hence, the limitation of the liability of the shareholders while the directors are potentially liable for the entire amount of the company’s tax liability reflects the greater power of the directors to manage the affairs of the company, in particular, the power to determine whether the company enters into an arrangement or not.

The background research indicates that it was contemplated that directors would have greater liability than shareholders because of their greater influence over the affairs of the company. A Report to the Ministers of Finance and Revenue from Treasury dated 30 July 1991 stated:

“This approach would provide a disincentive to directors and shareholders being party to an asset stripping arrangements while at the same time ensuring that shareholders with a controlling interest in a company who were not a party to the arrangements are not penalised too heavily by the company’s decision to proceed with that arrangement”.

The report also indicates that it was considered that where a shareholder does not have a controlling interest in a company but derives a benefit, an inference could be drawn that the shareholder was a party to the arrangement¹⁷⁵.

The joint Treasury and IRD report on submissions relating to the amendment of section 276¹⁷⁶ dated 24 January 1992 (“the Officials’ Report”) contains discussion of a

¹⁷⁰ Section 126(2) Companies Act 1993

¹⁷¹ Income Tax Act 2004

¹⁷² Income Tax Act section HK 11(10)

¹⁷³ Income Tax Act section HK 11(6)

¹⁷⁴ Income Tax Act 2004

¹⁷⁵ Income Tax Act section HK 11(4)(b)

submission that the liability of directors should be limited to the greater of the market value of the company at the time the arrangement was entered into and the value of any benefits derived from the arrangement. It was submitted that it was unfair to require directors and shareholders to guarantee the income tax liabilities of a company. This submission was declined because it was considered that it was not appropriate to limit the liability of the directors in that manner as the directors could reasonably be expected to have known of the arrangement and directors can escape liability if they satisfy the requirements of section HK 11(6)¹⁷⁷. The Report says:

As long as it is possible for dissenting directors to avoid liability under section 276 in certain circumstances (as proposed elsewhere in this report), the remaining directors are the proper target of the section. Such directors would be liable where it can reasonably be concluded that they knew or should have known of the actions pertaining to the asset stripping arrangements. Given this requirement, it is not considered appropriate to limit the amount of tax recovered as proposed in the submission.

Therefore, the relative roles and powers of the directors and shareholders are expressed by inference to specific reference to interest and late payment penalties in section HK 11(4)¹⁷⁸.

Subject to the time bar, an assessment of a company that has been liquidated may be issued or amended for the purposes of giving effect to section HK11¹⁷⁹ as if the company had not been liquidated. If an assessment is made or amended in respect of a company that has been liquidated, the CIR is required to nominate the person(s) whom the CIR considers to be liable for the tax liability specified in the assessment and that person(s) is/are to be treated as agent(s) of the company. This includes the right to challenge the CIR's application of s HK11¹⁸⁰.

The status of the company when the CIR seeks to apply the recovery section is a contentious point. This arises as a result of the tension between the role of the liquidator under the Companies Act 1993 and the Insolvency Act 1967, and the rights to object to

¹⁷⁶ Income tax Act 1976

¹⁷⁷ Income Tax Act 2004

¹⁷⁸ Ibid

¹⁷⁹ Ibid

¹⁸⁰ Ibid

the application of section HK11¹⁸¹. However, the objection procedure is depended on whether section HK11¹⁸² is a charging or recovery provision.

5. Meaning of ‘recovery’

Income tax is imposed on taxable income of a taxpayer for a tax year¹⁸³. This obligation is only discharged when Inland Revenue receives a tax return and payment, if any. Liability for income tax is imposed by the Income Tax Act and arises once an assessment has been made. An assessment quantifies a taxpayer’s tax liability¹⁸⁴. Therefore, before a debt in respect of tax can be recovered, an assessment is necessary to quantify the liability. The following comments in *CIR v Allen*¹⁸⁵ indicate that the assessment establishes the debt in respect of tax:

When the proceedings were issued there were assessments in place, which by reason of s 109 of the Tax Administration Act, established the indebtedness of Mr Allen. If the actions taken by Mr Allen constituted an effective challenge to those assessments with the effect that 50% of the amount assessed was no longer payable, this would fairly warrant the conclusion that judgment should not be entered against him on the assessments.

However, it is section 156¹⁸⁶ that authorises the CIR to recover all unpaid taxes for the crown.

The Concise Oxford Dictionary definitions of “recover” and “recovery” are:

Recover

Secure (restitution, compensation, damages or abs.) by legal process

Recovery

Act or process of recovering or being recovered.

In *Re Gilbert Machinery Co (No1)*¹⁸⁷ Stout CJ considered the meaning of the term “recover”:

The word “recover” has been held to mean something more than suing. In *Hanes v Welch* (1866) LR 4 Cp 91 “recover” was held to mean “to obtain in

¹⁸¹ Ibid

¹⁸² Ibid

¹⁸³ s 33 TAA 1994

¹⁸⁴ *Lemington Holdings Ltd v CIR* (1982) 5 NZTC 61,122; *CIR v Canterbury Frozen Meat Co* (1994) 16 NZTC 11,150

¹⁸⁵ [2004] 21 NZTC 18,718

¹⁸⁶ Tax Administration Act 1994

¹⁸⁷ [1906] 26 NZLR 47

any legal manner”, and hence it was said that it gave the right to distrain for rent by action, the learned and eminent judge, Mr Justice Wiles, saying

“The word ‘recover’ is now often used in the larger sense of obtaining in any legal manner”.

And a petition to wind up is a mode of obtaining in a legal manner the payments of debts: see per Richmond J in *Re Extended Wapato Gold Mining Company (Limited) Moore v Cuff and others* [1894]13 NZLR 544. In *Morris v Duncan* [19899] 1 QB 4 DC it was held that “recovery” did not limit the proceedings that could be taken to an action. A proceeding before Justices was authorised by the word “recover”. In *Howard v Baillie* (1796] 2 Hay Bal 618 it was said:

“Thus an authority to receive and recover debts includes a power to arrest”.

Now, the proceeding by petition is a mode of recovering a debt, for it is often successful without the proceeding to wind up being continued, and the petition may be withdrawn: see amongst many other cases to this effect, the case of *Re Times Life Assurance and Guarantee Company* (1869) LR 9 Esq 382. (p. 50)

Therefore, the recovery of tax means the process of recovery of a debt in respect of tax (quantified by an assessment) by legal means and the successful outcome of that process. It is therefore necessary to outline the purpose of section HK 11¹⁸⁸ in order to decide its relationship with sections 156¹⁸⁹.

The legislative history confirms that the objective of section HK 11¹⁹⁰ is to enable the CIR to recover outstanding tax. Even though there have been many modifications to this provision its purpose has not altered.

The Officials’ report to the amendment of section 276¹⁹¹ stated:

“... section 276 of the Income Tax Act is to be replaced with a better targeted provision. That provision will allow the Commissioner to recover tax from directors and shareholders of companies that have entered into arrangements or transactions to deplete the assets of the company so that it has been unable to meet its tax liability.

...

Recovery of the outstanding tax that results from these asset stripping arrangements will be sought from those taxpayers that were directors and shareholders of the company at the time the arrangement was entered into.

¹⁸⁸ Income Tax Act 2004

¹⁸⁹ Tax Administration Act 1994

¹⁹⁰ Income Tax Act 2004

¹⁹¹ Income Tax Act 1976

The Officials' Report also indicates that the exact liability of each director and shareholder was not specified to allow the CIR the same flexibility as any other creditor in respect of debt recovery:

The section does not prescribe how the liability will be allocated between the various parties and is typical of other sections that impute joint and several liability for tax (such as the trust provisions in the Act). This approach ensures that the Commissioner has the ability to operate as any commercial creditor would. Typically, in the commercial debt recovery field, recovery of the debt is first sought from those persons who are both easily accessible and financially liquid. To deprive the Commissioner of this ability is at odds with the philosophy that the Commissioner should operate under the standard commercial debt recovery procedures.

Section HK 11(7)¹⁹² and (8)¹⁹³ indicate that it was intended that any assessment necessary to give effect to section HK 11¹⁹⁴ would be made in respect of the company regardless of whether the company was still in existence. The debt of the company for income tax would be established by an assessment in respect of the company.

In my view, the difference between a charging provision and a recovery provision is that a charging provision imposes liability for income tax and permits an assessment to be made whereas a recovery provision relates to the mechanics of collection or recovery of a debt, the amount of which has been established and quantified by an assessment.

In *BNZ Finance Ltd v CIR*¹⁹⁵, which concerned section 276¹⁹⁶ in its original form, McKay J said:

As Richardson P has pointed out, the liability for tax is imposed by the Act itself: s 38(2). Other sections provide for the making of assessments, and for the payment and recovery of tax. The Commissioner may amend any assessment in order to ensure its correctness: s 23. The assessment process is therefore a step in the quantification of the underlying liability. It is subject to the objection procedure, and is subject to amendment. The liability exists, however, even before assessment.

Mr Harley, for BNZ Finance Ltd, submitted that s 276 was a collection or recovery provision, and not a charging provision. The wording of the section does not support this. The operative words are "shall be deemed to be the agent ... and shall be liable for all tax payable ...". These are not words

¹⁹² Income Tax Act 2004

¹⁹³ Ibid

¹⁹⁴ Ibid

¹⁹⁵ [1997] 18 NZTC 13,461 (PC)

¹⁹⁶ Income tax Act 1976

limited to the mechanics of collection or recovery. They are words imposing liability. (p. 13,165-13,167)

Thomas J said:

I consider that an interpretation restricting s 276(3) to a provision authorising the recovery of income tax which has been quantified, or which is capable of being quantified, at the time a company ceases to carry on business in New Zealand is an unduly strained construction of the subsection. (p. 13,171)

In *BNZ Finance Ltd v CIR*¹⁹⁷ the taxpayer argued that section 276¹⁹⁸ was a recovery provision rather than a charging provision in that it permitted the CIR to recover by way of demand an established debt but did not authorise an assessment to be made in respect of any person, including an agent and that the words “*liable to be assessed*” did not include a contingent liability. The issue of whether the former section 276¹⁹⁹ permitted an assessment to be made to BNZ Finance Limited was relevant because it was not possible to issue an assessment to the original company, BNZ Deposits Ltd (“Deposits”), a subsidiary of BNZ Finance Limited which had been struck off in 1994. Amended assessments for the 1989 and 1990 years issued by the CIR to Deposits in 1995 were nullities as it did not exist at the time the assessments were issued. The CIR subsequently wrote to BNZ Finance Limited advising that he intended to assess BNZ Finance Limited for the tax owed by Deposits under section 276²⁰⁰.

Under section 276²⁰¹ a “*new company*” was deemed to be the agent of the “*original company*”. The court considered that section 276²⁰² permitted the “*new company*” to be assessed for the tax liability of the “*original company*” as the general agency provisions²⁰³ applied to agents under section 276²⁰⁴. The general agency provisions under the Income Tax Act 1976 required agents to make returns in respect of income of which they were agents and to be assessed in respect of the income as if they were principals.

¹⁹⁷ Ibid

¹⁹⁸ Income Tax Act 1976

¹⁹⁹ Ibid

²⁰⁰ Ibid

²⁰¹ Ibid

²⁰² Ibid

²⁰³ Sections 266 to 273 Income Tax Act 1976(Sections HK1 to HK8 Income tax Act 2004)

²⁰⁴ Income Tax Act 1976

*BNZ Finance Ltd v CIR*²⁰⁵ concerned a case where the “original company” had not been assessed and it was no longer possible to assess the “original company” as it had been struck off. The case established that in those circumstances an assessment could be made in respect of the “new company”. The “new company” was liable for income tax for which the “original company” was “liable to be assessed”.

However, *Instant Finance Ltd v CIR*²⁰⁶ (which also related to the original form of section 276²⁰⁷) concerned a situation where a valid assessment had been made in respect of the “original company” and the “original company” had not objected to the assessment. *Instant Finance Ltd v CIR*²⁰⁸ established that in such circumstances the demand made by the CIR on the “new company” under section 276²⁰⁹ was also an assessment in a limited sense so that the “new company” had the right to challenge whether the condition for its liability under section 276²¹⁰ existed.

If section HK 11²¹¹ had been applied to the circumstances of the *BNZ Finance Ltd v CIR*²¹² case (that is, where an assessment had not been made before the company was struck off or where the Commissioner sought to amend an assessment after the company was struck off), section HK 11(7)²¹³ would permit any assessment required to establish the amount of the company’s tax liability to be made in respect of the company although the company had been liquidated. Where an assessment has been made in respect of a company that had been liquidated, the persons held liable under section HK 11²¹⁴ are entitled as agents of the company to receive notice of the assessment and to challenge the assessment [section HK 11(8)²¹⁵]. Therefore, unlike under section 276²¹⁶ in its original form, it is not necessary to establish that section HK 11²¹⁷ authorises an assessment in respect of the persons held liable.

²⁰⁵ [1997] 18 NZTC 13,461 (PC)

²⁰⁶ [1995] 17 NZTC 12,159

²⁰⁷ Income Tax Act 1976

²⁰⁸ *Ibid*

²⁰⁹ *Ibid*

²¹⁰ *Ibid*

²¹¹ Income Tax Act 2004

²¹² [1997] 18 NZTC 13,156 (CA); [1997] 18 NZTC 13,461 (PC)

²¹³ Income Tax Act 2004

²¹⁴ *Ibid*

²¹⁵ *ibid*

²¹⁶ Income Tax Act 1976

²¹⁷ Income Tax Act 2004

The procedures set out in section HK 11(7)²¹⁸ and (8)²¹⁹ were not followed in *Spencer & Anor v CIR*²²⁰ that involved an assessment in respect of the company of which Mr Prestidge was a director. This led to a finding that the assessment was invalid because the company did not exist at the time the assessment was made.

Section HK 11²²¹ contemplates that any assessment made would be made in respect of the company. That being the case, it could be argued that section HK 11²²² is a recovery provision in that it enables the recovery from the directors or shareholders of a debt of the company in respect of income tax, the amount of which is established by the assessment made in respect of the company.

However, the following obiter comments of Thomas J in the *BNZ Finance Ltd v CIR*²²³ indicates that he considered that section HK 11²²⁴ was not merely a recovery provision:

Although the new provision is much more comprehensive than the section it replaces, the same legislative approach is evident in both sections. The underlying concept of holding persons, whether substantially the same shareholders or the same directors who benefit from the cessation of the other company, liable as agents for the original company's tax liability is retained. **The amendment is clearly directed at liability for tax, whether determined or not, and cannot be construed as a "recovery provision".** The assumption may be plausibly made, I believe, that Parliament has approached the subject with a consistent mind, and to that extent it provides some support, albeit far from decisive, for the meaning sought by the Commissioner. (p. 13,176) [Emphasis added]

In the Officials' Report it was considered that generally the company should have the right to object to the assessment where the company still exists as the assessment relates to income of the company and that to provide additional objection rights to the shareholders in respect of the same issues would delay the recovery of tax. It was considered that objection rights should be given to the nominated agents where a company had ceased to exist and was, therefore, unable to object to an assessment. Therefore, it was considered, on submission, that the CIR should be required to give notice of assessments to all persons nominated as liable for the company's tax liability

²¹⁸ Ibid

²¹⁹ Ibid

²²⁰ [2004] 21 NZTC 18,818

²²¹ Income Tax Act 2004

²²² Ibid

²²³ [1997] 18 NZTC 13,461

²²⁴ Income Tax Act 2004

(in order to ensure that such persons have a right to object to the assessment) should be rejected:

Section 276(7) [section HK 11(7)] operates only for companies that have been wound up and does not cover companies still in existence.

In the event that the company has wound up and a new or amended assessment is issued, the nominated agents will be liable for any tax. These agents will have the usual objection provisions available to them. This is necessary as the company cannot object to the re-assessment given that it is no longer in existence.

For the more general case where the company is still in existence, given that it is the company being reassessed, it is the company that has the right of objection. This is important given the record requirements and other provisions of the Act. The nominated agents do not have any tax assessed – they are merely liable for the company tax as agents. Therefore, they do not have the objection procedures available to them. To allow individuals to have additional objection procedures would result in the same issues that were litigated or discussed with the company being raised again. A consequence would be a further delay in the recovery of tax due to the revenue.

The Officials' Report also indicates that it contemplated the procedure for notifying directors and shareholders of their liability under section HK 11²²⁵ would be by way of notice of recovery rather than by way of assessment. In response to a submission that directors and shareholders should become liable once the CIR has nominated them and that the CIR should be required to nominate all parties to the arrangement as liable, the Officials considered:

The mechanism for notification of directors and shareholders of their liability will be via a notice of recovery rather than a reassessment of the directors or shareholders. The ability of the Commissioner to choose the persons from whom he seeks recovery is consistent with existing commercial practices. Typically, this will be from the person who is both easily accessible and financially liquid. To deprive the Commissioner of this ability is at odds with the philosophy that the Commissioner should operate under the standard commercial debt recovery procedures.

As with commercial practice for debt recovery, nominated persons are liable for the full amount of the liability. It is up to them to seek compensation for any amount recovered from them that exceed what they perceive to be their share of the liability.

Therefore, the liability imposed by section HK 11²²⁶ is not a liability to be assessed; it imposes a liability on the agent to pay the income tax liability owed by the company. Whilst section HK11²²⁷ extends the liability of directors beyond the

²²⁵ Income Tax Act 2004

²²⁶ Ibid

²²⁷ Ibid

traditional realms of director's duties the CIR still has an overriding obligation to acknowledge taxpayer's rights including taxpayers who are deemed agents of other taxpayers who have an outstanding tax liability. There is still a large amount of work required in this area to allow this recovery mechanism to operate as legislation intended.

I. Tax & the corporate veil

Section HK11²²⁸ makes directors and shareholders of a company liable for company tax in certain situations thus piercing the corporate veil. Piercing the corporate veil is something that courts are generally reluctant to do, and section HK11²²⁹ is rare in that it specifically prescribes a situation in which the courts are allowed to pierce the veil.

A common misconception is that imposing liability on directors of the company is not recognised as piercing the corporate veil, as directors are part of the company. And, it is only when liability is imposed on shareholders beyond their liability for the value of their shares that the corporate veil is genuinely pierced. But, directors could also be shareholders which often occur with smaller entities that are owner operated. Furthermore, regardless of whether corporate liability is imposed on shareholders or director the fact remains that the debts of the company are imputed to such third parties. Imposing liability on directors is specifically regarded as piercing the corporate veil.

The purpose of the section is to make liable for the tax of a company those persons that had sufficient control of the company when it entered into an arrangement that left the company unable to meet its tax liabilities. It is not just directors and controlling shareholders that may be liable for the company's tax, but also non-controlling shareholders who, it is reasonable to conclude, were parties to the arrangement.

There are four requirements for the section to apply:

1. The arrangement must be entered into in relation to a company;
2. One of the effects of the arrangement must be that the company is unable to meet its existing or subsequent tax liability;

²²⁸ Ibid

²²⁹ Ibid

3. A director having made reasonable inquiries would have realised that a tax liability existed;
4. It is reasonable to conclude that a purpose of the arrangement was to leave the company unable to meet its tax liability

Imposing liability on shareholders for the liabilities of a company is the act that actually pieces the corporate veil. However, under section HK11²³⁰ directors may also be held liable for the company's tax liability. Any director at the time of the arrangement is "jointly and severally" liable for the tax liability of the company. "Jointly and severally" means that directors can be held liable either all together or a single director can be held liable for the entire amount.

Any director can escape liability on the basis that the director did not know of the arrangement at the time it was entered into and was not involved in the management of the company at the time. The director must also register his or her objection to the arrangement with the Company as soon as he or she becomes aware of it and notify the Commissioner of the arrangement and the objection to it. The director must also not have received any benefit from the arrangement.

Two types of shareholders may also be held liable for some of the tax liability of the company. First, controlling shareholders can be held liable. A controlling shareholder is a person who, together with an associated person, holds 50% or more of the voting shares in the company or 50% more of the market value of the company. Secondly, a non-controlling shareholder can be held liable for some of the tax liability of the company if, at the time the arrangement was entered into, having regard to the benefit the person received from the arrangement, it is reasonable to conclude that the person was a party to the arrangement.

Directors and shareholders are not normally liable to pay company tax; the primary liability rests with the company. This is a consequence of the principle of corporate personality, that the taxes are those of the company and not the directors and shareholders.

²³⁰ Ibid

However, section HK11²³¹ recognises that there will be occasions where it is appropriate for the CIR to look beyond the guise of the company to those people who are in control of the asset stripping exercise. This helps to maintain the integrity of the tax system thereby preventing the tax base from being eroded by the action of negligent or fraudulent directors. It is yet to be determined what effect the application of section HK11²³² has on the rights of a director and shareholder to challenge the underlying tax liability that the company is unable to satisfy.

J. Summary

In summary, it is considered that the application of section HK11²³³ is a hypothetical test and requires:

- An arrangement, being a contract, agreement or understanding, enforceable or unenforceable, including all steps and transactions to carry it into effect, has been entered into in relation to a company; and
- An effect of the arrangement (being any one result or consequence or end accomplished of the arrangement) is that a company is unable to meet a likely tax liability; and
- It can be concluded on an objective basis that a director of reasonable competence at the time of entry into the arrangement, who made all reasonable inquiries into the affairs of the company would regard as probable at that time that a tax liability would be required to be satisfied; and
- It can be concluded on an objective basis that a purpose of the arrangement, which when considered objectively, was to have the effect of depleting the assets of the company so that the company was unable to meet a likely tax liability.

If the requirements of section HK11²³⁴ are satisfied, all directors at the time of entry into the arrangement are jointly and severally liable for the tax liability of the company, that liability being inclusive of interest and civil penalties.

²³¹ Ibid

²³² Ibid

²³³ Ibid

²³⁴ Ibid

However, a director is not liable for a tax liability if the CIR is satisfied that the director derived no benefit from the arrangement and either formerly dissented to the arrangement or was not involved in the executive management of the company and had no knowledge of the arrangement

VII. ALTERNATE REMEDIES

A. Commercial Law

One of the main reasons for establishing a company when beginning business, instead of operating for example as a sole trader, is to limit the liability of shareholders. The reasons companies have a separate legal personality are mainly to enable investors to pool their capital/resources and then to delegate management of the company to ‘expert’ managers aka directors. The law limits the liability of the investors to the extent of their investments/contributions (i.e. paid up share capital) to enable this capital-pooling and delegation of management arrangement to work.

Limited Liability is a privilege which should not be abused at the expense of the creditors of the company. It is immediately concerning when a company is established with one shareholder who is also a director. Given that there is no pooling of capital and no delegation of management in such scenarios, it is apparent that probably the main motive for forming such a company is to take advantage of the privilege of limited liability at the expense of creditors of the company.

Accordingly, the potential and incentive for abuse of the corporate veil and defrauding of creditors of the company is high risk in such scenarios. Setting up a company does not, however completely absolve shareholders and, more particularly directors from potential personal liability

The Companies Act 1993 reinforces the statutory obligations of directors and provides mechanisms by which liquidators, in particular, can pursue actions against directors and shareholders to recover shortfalls to the company’s creditors. These remedies or actions are only available to a liquidator of a company and not a receiver (except in the case of overdrawn current accounts).

The possibility of recovering money or assets from directors or shareholders is one of the principle reasons why Inland Revenue should not give up on potential recoveries of debt after a company goes into liquidation, even where a company has no obvious assets. However, these actions are expensive and time consuming.

a. Separate legal personality

A company is a separate legal entity from those who may own shares or be involved in the running of the company. The company, as a 'person' is distinguished from its members. A shareholder's liability to the debts of a limited liability company is limited to the amount unpaid on shares and in the vast majority of cases is zero. This means that the company is fully liable. However, this protection can be lost if the director/shareholder is reckless in giving personal guarantees. The effect of companies being a separate legal person was recognised and entrenched by the decision of *Salomon v. Salomon & Co Ltd*²³⁵.

Mr Salomon was a successful boot and shoe manufacturer. Mr Salomon formed a company and sold his sole trader business to the newly established company. Mr Salomon and members of his family were the only shareholders of the company. The company was funded primarily through share capital and debentures issued to Mr Salomon. Shortly after the company started trading, it fell upon hard times. Despite efforts by Mr Salomon to rescue the company it was liquidated.

When the company failed, the value of its assets was insufficient to satisfy all debts. Mr Salomon as debenture holder was entitled to preferential status above other creditors. The liquidator claimed that the company was a sham and brought proceedings against Mr Salomon.

The House of Lords held:

"Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr Salomon. If it was not, there was no person and no thing to be agent at all; and it is impossible to say at the same time that there is a company and there is not".

The House of Lord's decision recognises that the limited liability and the protection of shareholders and directors from responsibility for acts done in the name of the company are consequences of incorporation. That in itself is a mechanism that recognises the concept of separate legal personality.

²³⁵ [1897] AC 22

This principle has been codified in New Zealand under section 15²³⁶. However, in one such case, *Trevor Ivory Ltd v Anderson*²³⁷, the court found that where there was a breach of a duty of care by a director that director may be held personally liable for negligence. Cook P stated at page 67,617:

“When he formed the company, Mr Ivory made it plain to all the world that limited liability was intended...such a limitation is a common fact of business and, in relation to economic loss and duties of care, the consequences should in my view be accepted in the absence of special circumstances”.

This comment illustrates that the Court is prepared to look through the separate personality of a company in certain circumstances which includes through to the actions of the director (s).

b. Corporate Veil

Despite the principle of separate legal personality of a company the courts are often asked to ignore this principle. However, due to the separate legal personality principle of companies it is said that a veil exists between a company and its participants. Occasionally the courts will adopt ‘lifting the veil’. What this effectively does is treat one or more of the company’s participants and the company as one and the same person. Creditors who want participants such as shareholders or directors held personally liable for the company’s debt may invoke veil piercing remedies.

However, there is no simple principle that the courts have adopted. Incorporation does not fully “cast a veil of a limited liability company through which the courts cannot see”²³⁸, but generally, the court is more likely to ‘lift the veil’ if fraud existed at inception. By looking through the veil of incorporation the Court is able to discover the person (s) in control and impose liability on them.

²³⁶ Companies Act 1993

²³⁷ [1992] 6 NZCLC 67,611

²³⁸ *Littlewoods Mail Order Stores Ltd v McGregor* [1969] 3 All ER 855, per Denning MR.

B. Companies Act 1993

If a person in a fiduciary position breaches his fiduciary duties the law usually attracts ‘strict liability’ to such persons (e.g. trustees, directors, etc). The Companies Act 1993 imposes many obligations on directors and these are found throughout the Act²³⁹. A breach of any one of these provisions may result in civil and possibly criminal liability. However, this dissertation is only concerned with section 135, 136 and 301²⁴⁰. Breaches of both section 135²⁴¹ and section 136²⁴² can give rise to a personal liability for directors via the remedy provided for in section 301²⁴³.

However, in order to hold director personally liable for the company’s debt the director must have allowed the company to trade while being insolvent. Insolvency involves a two pronged test - where a company is unable to pay its debts as they become due (cash flow) or the liabilities exceed its assets (balance sheet). These two tests were imported from Australia – section 588G²⁴⁴(cash flow) and England – section 214²⁴⁵ (balance sheet).

Section 4²⁴⁶ defines solvency as:

Meaning of “solvency test”--- (1) For the purposes of this Act, a company satisfies the solvency test if---

- (a) The company is able to pay its debts as they become due in the normal course of business; and
- (b) The value of the company's assets is greater than the value of its liabilities, including contingent liabilities.

In *Mountfort v Tasman Pacific Airlines of NZ Limited*²⁴⁷ Baragwanath J stated at paragraph 20-21:

“I am satisfied that the “general obligation...to maintain the company’s capital”...has now been superseded by what may be expressed as a general albeit imperfect obligation not to trade while insolvent, which is to be inferred from the whole scheme of the Act. The obligation to maintain solvency could not be absolute, because that would destroy the very justification for limited liability which requires the protection of directors

²³⁹ Section 56, Section 131 to section 137, etc.

²⁴⁰ Companies Act 1993

²⁴¹ Ibid

²⁴² Ibid

²⁴³ Ibid

²⁴⁴ Corporations Act 2001

²⁴⁵ Insolvency Act 1986

²⁴⁶ Companies Act 2004

²⁴⁷ [2005] CIV-2004-404-1843

who, acting reasonably and in good faith, are unable to prevent failure that is both a regular fact of business life and the justification for limited liability. The obligation is imperfect breach does not, per se, attract legal consequences for the directors. But it is nevertheless an obligation because it is the premise on which there is unconditional entitlement to continue to trade.

Such conclusion is consistent with the explicit obligations now stated in ss ...135 (not to allow substantial risk of serious), 136 (need for belief on reasonable grounds in ability to perform obligations)...are mandatory”

Baragwanath J went on to hold that where a company is insolvent (i.e. unable to pay debts on due date or liabilities exceed assets) then the directors have a duty to place the company in liquidation in order to avoid further risk/prejudice to creditors of the company.

a. Section 135²⁴⁸ – Reckless Trading

135. Reckless trading---A director of a company must not---

- (a) Agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
- (b) Cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

Section 135²⁴⁹ sets out an objective test for reckless trading and can potentially create a liability for directors before insolvency. This wide application perhaps acts as a deterrent for directors, although the Courts have been very cautious about applying this section to companies which are not insolvent or not near insolvency.

In order for this provision to be invoked there needs to be a “substantial risk” or “serious loss”. In *Re Wait Investments Ltd (in liq.); McCallum & Petterson v Webster*²⁵⁰ the courts held that there must be something in the financial position of the company that would have put an ordinary prudent director on notice to the likelihood that entering into the transaction would cause a serious loss (more than minor or insignificant) to the company’s creditors. Even though this case related to section 320²⁵¹ it has similar language to the present section 135²⁵² which suggests that the approach taken by the courts are equally valid to the present provision.

²⁴⁸ Companies Act 1993

²⁴⁹ Ibid

²⁵⁰ [1997] 8 NZCLC 261,384

²⁵¹ Companies Act 1955

²⁵² Companies Act 1993

In *Nippon Express (NZ) Ltd v Woodward*²⁵³, an unsecured creditor brought a reckless trading action against two directors of the liquidated company. The Court held the directors were liable on the basis that they failed to make proper inquiry into the state of the business. They simply relied on the dishonest advice of the managing director. This was despite of the fact that both directors also suffered personal financial loss due to the managing director's fraudulent actions.

In *Re Gellert Developments Ltd (in liq.); McCullagh v Gellert*²⁵⁴ directors were held to be in breach of their duties to creditors by authorising payments of excessive salaries to themselves during a period when the company was facing insolvency. It was an attempt by the directors to strip the assets of the company. If the CIR had been a creditor in this case, it may have been a suitable case to apply section HK11.²⁵⁵

Based on the case law surrounding the application of section 135²⁵⁶, it is clear that a court will not recognise a liability without applying the objective standard of a "reasonable, prudent director" and the company needs to be experiencing or exposed to financial difficulties. This sets the parameters for when a creditor can take action under section 135²⁵⁷.

Interestingly, there are no reported cases on section 135²⁵⁸ involving the CIR as a creditor of an insolvent company. Why is this? It could be a reluctance to use Companies Act remedies, or a preference for other avenues of recovery. Given the growth of complex debt over the last few years my view is the former. The other reason why I think the former is a good choice is due to recent efforts by IRD to rid itself of its past poor public image. However, this strategy could prove detrimental to maintaining the integrity of the tax system.

But, it must be remembered that the awards made by the Court depend on the practicalities in each case. If the CIR is the only creditor in the liquidation then the court would most likely award directly to the CIR, if the CIR is the plaintiff who took the action where the liquidator was negligent/intransigent/conflicted etc. Nevertheless, the

²⁵³ [1998] 8 NZCLC 261,765

²⁵⁴ [2002] 9 NZCLC 262,942

²⁵⁵ Income Tax Act 2004

²⁵⁶ Companies Act 1993

²⁵⁷ Ibid

²⁵⁸ Ibid

CIR ought to use the full force of the law when warranted. This would protect the integrity of the tax system as well as promote voluntary compliance.

b. Section 136 – Duty in Relation to Obligations

136. Duty in relation to obligations---A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

This provision prohibits a director from agreeing to a company incurring an obligation unless the director reasonably believes that the company will be able to fulfil its obligation as and when required. This provision is often invoked alongside section 135²⁵⁹.

In *Fatupaito v Bates*²⁶⁰ the court found that section 136²⁶¹ comprises both an objective and subjective test. This case concerned the appointment of the company’s accountant as receiver when the company was in financial difficulty. The company was allowed to continue trading but then went into liquidation. O’Reagan J held that the accountant knew the company was insolvent and therefore it was not reasonable for him to believe that the obligation incurred by the company would be met.

In order to demonstrate a breach of this provision, a liquidator must show that the director agreed to the company incurring an obligation at a time when the director did not believe on reasonable grounds that the company would be able to perform that obligation when required to do so. The subjective test is the “belief of the directors” and the objective test is that the “belief” must be on “reasonable grounds”.

In *Re Hilltop Group Limited (in liq.); Lawrence v Jacobson*²⁶² a director was found to be in breach of section 136²⁶³ because he had transferred the business with an inflated goodwill value at a time when he knew the company was in decline and had lost a major customer. The Court applied the test of a reasonable prudent director and

²⁵⁹ Ibid

²⁶⁰ [2001] 9 NZCLC 262,583

²⁶¹ Companies Act 1993

²⁶² [2001] 9 NZCLC 262,477

²⁶³ Companies Act 1993

concluded that a reasonable prudent director in a similar position would not have allowed the business to be carried on to continue to incur obligations while insolvent.

In *Walker v Allen*²⁶⁴ excise duty for the purchase of alcohol was owed by the company to the New Zealand Customs. The excise duty remained unpaid for a significant period which prompted the New Zealand Customs to commence liquidation proceedings. This debt led to legal action being taken against the director. The Court held that the action of the managing director went beyond any legitimate business risk which comprised of taking illegitimate business risks. Furthermore, the shortcoming of the director was also linked to failure to keep proper accounting records.²⁶⁵

c. Section 301²⁶⁶ – Power of Court to Require Persons to Repay Money or Return Property

301. Power of Court to require persons to repay money or return property---(1) If, in the course of the liquidation of a company, it appears to the Court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, the Court may, on the application of the liquidator or a creditor or shareholder,---

(a) Inquire into the conduct of the promoter, director, manager, liquidator, or receiver; and

(b) Order that person---

(i) To repay or restore the money or property or any part of it with interest at a rate the Court thinks just; or

(ii) To contribute such sum to the assets of the company by way of compensation as the Court thinks just; or

(c) Where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the Court thinks just to the creditor.

(2) This section has effect even though the conduct may constitute an offence.

(3) An order for payment of money under this section is deemed to be a final judgment within the meaning of section 19 (d) of the Insolvency Act 1967.

This section provides that on liquidation of the company, a present or past director who is guilty of breach of a company duty may be ordered to contribute an amount as determined by the Court to the assets of the company by way of

²⁶⁴ [2004] HC, Nelson CP 13/00

²⁶⁵ Section 194 Companies Act 1993

²⁶⁶ Companies Act 1993

compensation. An application under this section can be either by a liquidator, shareholder or creditor of the company. This section is the instrument by which a creditor would seek to be recompensed by the director, if the creditor suffered a serious loss to which section 135 and section 136²⁶⁷ applied because neither of these sections themselves contains a remedy.

In summary, while both section 135 and 136²⁶⁸ appear to present problems in interpretation and application due to the language used in each section, especially in relation to duties owed to creditors, the abundance of reported cases clarifies their application. This means that there is legal certainty, unlike the problems with interpretation that exist with section HK11²⁶⁹. However, there are some recurring themes evident in a number of the decisions on these sections. The duties owed to creditors created under these sections for directors, require the company to be near insolvency or insolvent. This requirement stems from the creditors position on insolvency given that that the company's assets are held for the benefit of creditors because the company is not in a positions to pay its debts.

Another aspect of the directors duties created under section 135 and 136²⁷⁰ is that directors must also apply an objective test to meeting their obligations. In other words, there must be commercially viable reasons for their actions, taking into account the financial situation of the company and the potential loss to creditors as a result of their directives.

C. Other Options

a. Fair Trading Act 1986 [s45 (2)]

45. Conduct by servants or agents---(1) Where, in proceedings under this Part of this Act in respect of any conduct engaged in by a body corporate, being conduct in relation to which any of the provisions of this Act applies, it is necessary to establish the state of mind of the body corporate, it is sufficient to show that a director, servant or agent of the body corporate, acting within the scope of that person's actual or apparent authority, had that state of mind.

²⁶⁷ Ibid

²⁶⁸ Ibid

²⁶⁹ Income Tax Act 2004

²⁷⁰ Companies Act 1993

- (2) Any conduct engaged in on behalf of a body corporate---
- (a) By a director, servant, or agent of the body corporate, acting within the scope of that person's actual or apparent authority;
or
 - (b) By any other person at the direction or with the consent or agreement (whether express or implied) of a director, servant, or agent of the body corporate, given within the scope of the actual or apparent authority of the director, servant or agent---

shall be deemed, for the purposes of this Act, to have been engaged in also by the body corporate.

This provision makes it clear that both a company and the director of that company can be held liable for the same illegal conduct in relation to a breach under the legislation. The purpose of the legislation is to prevent misleading and deceptive conduct in business.

In *Rural Management Ltd v Commerce Commission*²⁷¹ the High Court held both the company and its director liable for misleading conduct in connection with the advertising of a subdivision, with the director being held liable as the principle offender. The Court held that the director knew that the statements the company were making in relation to the subdivision were false.

In *Ascot Travel Ltd v Brock*²⁷² the Court held that the director was personally liable for the forecast of the company's income. This income was misrepresented and misled the purchaser who fulfilled performance under the contract of sale. The company's income was part of the information for the sale of the business. Williams J said at p 18:

“this is not a case where there is sufficient to displace the normal presumption that a director, making representations on behalf of a company for the sale of some of the company's assets, was acting in a manner which does not incur personal liability for the representations.”

b. Commerce Act 1986 [s90]

90. Conduct by servants or agents---(1) Where, in proceedings under this Part of this Act in respect of any conduct engaged in by a body corporate, being conduct in relation to which any of the provisions of this Act applies, it is necessary to establish the state of mind of the body corporate, it is sufficient to show that a director, servant or

²⁷¹ [4 October 1996] HC, Christchurch AP 243/95

²⁷² [30 November 1999] HC, Auckland AP79-SW99

agent of the body corporate, acting within the scope of his actual or apparent authority, had that state of mind.

(2) Any conduct engaged in on behalf of a body corporate---

- (a) By a director, servant, or agent of the body corporate, acting within the scope of his actual or apparent authority: or
- (b) By any other person at the direction or with the consent or agreement (whether express or implied) of a director, servant, or agent of the body corporate, given within the scope of the actual or apparent authority of the director, servant or agent---

shall be deemed, for the purposes of this Act, to have been engaged in also by the body corporate.

(3) Where, in a proceeding under this Part of this Act in respect of any conduct engaged in by a person other than a body corporate, being conduct in relation to which a provision of this Act applies, it is necessary to establish the state of mind of the person, it is sufficient to show that a servant or agent of the person, acting within the scope of his actual or apparent authority, had that state of mind.

(4) Any conduct engaged in on behalf of a person other than a body corporate---

- (a) By a servant or agent of the person acting within the scope of his actual or apparent authority; or
- (b) By any other person at the direction or with the consent or agreement (whether express or implied) of a servant or agent of the first-mentioned person, given within the scope of the actual or apparent authority of the servant or agent---

shall be deemed, for the purposes of this Act, to have been engaged in also by the first-mentioned person.

(5) A reference in this section to the state of mind of a person includes a reference to the knowledge, intention, opinion, belief or purpose of the person and the person's reasons for that intention, opinion, belief or purpose.

This provision is another example of a statutory exception to the principle of separate legal personality. The purpose of this act is to promote competition.²⁷³ It recognises that if an offence requires proof of the state of mind of corporate entity, then it is sufficient to show the state of mind of a director, servant, or agent of that corporate entity. The conduct of a director, servant or agent of a corporate entity can be deemed to be conduct of that corporate entity in certain circumstances.

In *Giltrap City Ltd v Commerce Commission*²⁷⁴ the Court of Appeal established that the Chief Executive Officer of a car-dealing company was held to have entered into price- fixing agreements on behalf of the company with other car-dealers. The actions of

²⁷³ Section 2 of the Commerce Act 1986

²⁷⁴ [2004] 1 NZLR 608

the Chief Executive Officer were held to be both his own as well as those of the company and both were liable under section 90.²⁷⁵

The above alternatives, similar to that of section HK11²⁷⁶ are where the legislature has provided for the statutory piercing of the corporate veil. They illustrate that the culpability of a company can extend to its agents and associated entities where their conduct and actions lead to a dispute. They require Courts to confer blame beyond the corporate personality.

²⁷⁵ Commerce Act 1986

²⁷⁶ Income Tax Act 2004

VIII. OVERSEAS EXPERIENCE

A. Australia

When income tax becomes due in Australia, it is a debt owed to the Commonwealth of Australia²⁷⁷. Tax debt is a civil liability and failure to make payment of tax exposes the taxpayer to civil remedies. Unpaid tax may be sued for and recovered as a civil debt in any court for the recovery of unpaid tax²⁷⁸. Tax includes penalty tax²⁷⁹. However, a criminal offence may be committed where arrangements are entered into with the purpose of rendering a company unable, or likely not to be able to pay tax. The intentional stripping of company's assets so that it is unable to pay its debts is a long standing problem in Australia, similar to that experienced in New Zealand.

In the 1970s avoiding company tax was on the increase in Australia. This involved either stripping a company of its assets before tax became payable, or using another company which became liable for the tax liability but that company never had sufficient assets to pay the tax. This phenomenon became known as "bottom of the harbour" schemes because the records of the stripped companies were, metaphorically, retired to the bottom of Sydney Harbour once they had served their purpose.

The growth of tax avoidance schemes in the 1970s was mass marketed. Strangely though the Courts at that time seem to have taken a lenient approach in regards to this phenomenon as witnessed in *Curran v FC of T*²⁸⁰ and *Slutzkin v FC of T*²⁸¹. These cases provide examples of the odd compassion tolerated by the courts which in many cases bordered on fraud. This only encouraged the massive frauds on the revenue and they flourished.

A tax investigation in Perth identified a few cases where assets were being stripped from companies leaving the company unable to satisfy its tax liability. This sparked a wave of events that that ended up with the government taken action. It was uncertain whether these schemes constituted tax avoidance, minimisation or evasion.

²⁷⁷ Schedule 1 s 255-5(1) Tax Administration Act

²⁷⁸ Schedule 1 s 255-5(2) Tax Administration Act

²⁷⁹ Income Tax Assessment Act 1936 former Part VII

²⁸⁰ 74 ATC 4296

²⁸¹ 140 CLR 314

The government's action resulted in the enactment of the *Crimes (Taxation Offences) Act 1980*. This Act imposed severe penal sanctions to counter arrangements designed to prevent tax being collected from companies and trustees. The legislation targeted "bottom of the harbour" arrangements. Unlike other anti-avoidance legislation, this Act was designed to penalise the avoidance of payment, rather than the avoidance of tax assessment.

Under that Act it became a criminal offence for any person to make a company or trust unable to pay tax debts or to aid or abet any person or company doing so. The Act thus caught both, those in the schemes and the promoters of such schemes. This Act was controversial at the time, since tax avoidance was regarded as something less than an outright crime. Tax matters might normally be addressed by closing a revenue loophole, the act instead treated bottom of the harbour schemes like frauds.

However, a person cannot be convicted of more than one offence under the Act in relation to the same arrangement or transaction. This ensures, for example, that a person who is a party to an arrangement designed to frustrate collection of tax and who also aids or abets someone else to enter the arrangement may be convicted of either offence, but not both.

Australia then introduced the *Taxation (Unpaid Company Tax) Assessment Act 1982*. This Act went further, allowing for the recovery of tax avoided under "bottom of the harbour" tax schemes retrospectively.

It is not clear why the Australian Tax Office did not apply section 588G²⁸² or at least place pressure on liquidators to apply section 588G²⁸³ (i.e. insolvent trading which is akin to reckless trading) as this remedy could address the mischief but this remedy is apparently an underutilised remedy. It has not failed creditors; it has simply not been tested or tried. A reason may be that liquidators are reluctant to engage in civil litigation without funding for such actions.

It is unclear whether the Australian Tax Office has conducted a proper investigation into the remedies available in the Corporations Act 2001 and considered why such remedies are not being adequately applied. ASIC (the Companies Regulator)

²⁸² Corporations Act 2001

²⁸³ Ibid

may also wish to participate in a research exercise to consider whether companies are being abused for tax evasion purposes.

B. United Kingdom

The most pertinent tax provision relating to personal liability for company tax seems to be sections 189 & 190²⁸⁴. These provisions give powers of recovery of unpaid corporation tax against a shareholder who has received a capital distribution from the company, where that capital derives from a disposal of assets. The latter section gives rights of recovery against other group companies and controlling directors for unpaid corporation tax on gains realised by a UK resident company. These seem to fit with the idea of protecting HM Revenue & Customs against 'asset stripping'. No information was able to be obtained on how these work and the fact that the experts were scratching their heads to find any provisions in the first place suggests they are of limited use.

There are provisions in the Companies Acts 2006 which are the responsibility of BERR (Department for Business, Enterprise and Regulatory Reform). However, the usual position is that the debt of the company is owed by the company and only the company. Director's liabilities are contained under sections 212 to 216²⁸⁵. These provisions provide that a negligent or fraudulent director can be made personally liable for the debts owed by the company.

As an example, in England football is a very popular sport. This popularity grew to such an extent that it surpassed the notion of sport and entered the arena of business. This saw players being paid to play football. Football clubs then set up companies to limit liabilities of their directors. The Football Association recognised the danger this posed and introduced rules to prevent asset-stripping of grounds and the leaching of money as payments to directors. Sadly, these fears proved well-founded in recent years. This occurred in the case of the ex-Chairman of Bradford City Football Club. This case involved a tax scheme in which a group company was asset stripped leaving it insolvent and in debt. The Chairman was held to be in breach of his director's duty to that company.

²⁸⁴ Taxation of Chargeable Gains Act

²⁸⁵ Insolvency Act 1986

Similarly, a director can be made liable in cases of “phoenixism” for all the debts of his second company. “Phoenixism” is used to describe the practice where directors carry on the same business or trade successively through a series of two or more companies. Each of the companies in turn becomes insolvent, leaving large unpaid tax debts. A company typically transfers its business, minus its debts, to the next company. Only essential trade creditors are paid in full before the transfer. Often taxes remain unpaid. “Phoenixism” is the practice of liquidating a company to avoid paying off creditors and establishing the same firm under a new name shortly thereafter.

There are also certain provisions of the PAYE legislation which allow for directions to be made against employees who knowingly receive emoluments without PAYE being directed. In practice this only really bites on directors of small companies, and even then it can be hard to make stick.²⁸⁶ This case is a good example of the corporate veil operating in United Kingdom tax.

Certain legislation²⁸⁷ under the Companies Act 2006 does ensure that liabilities stay within a group. This is a form of imputing liability to shareholders and rests on the liability being unlikely to be paid. Unfortunately, cases under this provision have yet to be heard.

In 2005, measures aimed at tackling tax fraud and tax avoidance were announced. These measures were to protect the tax system from abuse and to ensure that an unfair burden does not fall on the vast majority of taxpayers who pay their taxes. Many of these measures have been informed by the disclosure rules introduced in Finance Act 2004, which allow HM Revenue and Customs (HMRC) to identify and target specific risks to the tax system. The measure announced that may be relevant to this dissertation is the transfer of assets abroad.

This remedy is to stop UK-resident individuals avoiding tax by exploiting offshore companies and trusts. Changes to the transfer of assets abroad legislation will tighten the rules for exemption from liability and close loopholes.

²⁸⁶ see *Pawlowski v Dunnington* [1999] STC 550

²⁸⁷ Section 776A

In summary, in the United Kingdom: - if a company is insolvent and it seems that the Revenue's claims will not be paid in full, there are recovery measures which seek to recover the debt from another person. The Revenue's rights to collect the company's debt from third parties are:

- the collection of capital gains tax from a trustee, done or debtor's spouse;
- corporate tax from members in a group of companies or shareholders or others who have received distribution of capital following a sale of property;
- The recovery of PAYE from employees (usually directors of a company)²⁸⁸

While there appears to be some provisions, available for HM Revenue & Customs it is of limited use. It was very difficult to find cases law on its application and consultation with experts in the UK via email proved it limited use. It would appear that the preference would be for Companies Act remedies.

C. Canada

Canada also does not have a specific provision in its Income Tax Act that deals with asset "stripping arrangements" such as that found in New Zealand or the "bottom of the harbour" schemes found in Australia. However, any taxes, interest and other amounts payable under the Acts are debts due to Her Majesty and recoverable as such in court or in any other manner provided by the Acts.

Even though no specific provision exists in the Income Tax Act in Canada the Commissioner has many provisions spread across the Revenue Acts that can assist to remedy any abuse or mischief by delinquent directors. There are other provisions such as section 325²⁸⁹ which hold a purchaser liable for company tax where a person sells some or all of its assets at less than fair market value. This provision tends to target mainly transactions between associated parties. It is unlikely that this provision will help with collecting unpaid company taxes due to "asset stripping" arrangements.

However, the tax evasion provisions contained within the Income Tax Act appears to have the ability to attack "asset stripping" arrangements. While no judicial

²⁸⁸ Income Tax (Employment) Regulations 72(1) to (6) and Income tax (PAYE Regulations 2003(s12003/2682)) 81(1) to (5)

²⁸⁹ Income Tax Act

evidence has been obtained to confirm this assertion, reading the provision shows no reason why this cannot be utilised. The pertinent part of the provision reads:

“(1) Every person who has...*(d)* wilfully, in any manner, evaded or attempted to evade compliance with this Act or payment of taxes imposed by this Act,...is guilty of an offence and, in addition to any penalty otherwise provided, is liable on summary conviction to
(f) a fine of not less than 50%, and not more than 200%, of the amount of the tax that was sought to be evaded, or
(g) both the fine described in paragraph 239(1) *(f)* and imprisonment for a term not exceeding 2 years.”²⁹⁰

The problem with this provision is that it is not clear as to who the “person” being referred to is. It can only be assumed that because a company is an artificial person it must refer to the controlling mind of the company. But this then calls into question the separate legal personality and corporate veil issue. So while this provision exists, I am not convinced that it achieves the outcome intended by section HK11²⁹¹.

More compelling provisions within the Revenue Acts are those referred to as “Directors’ Liability” provisions. The basic rules of liability are that the Canada Revenue Agency (“CRA”) must demonstrate its inability to recover amounts directly from the company and proceedings against the directors began within two years of the director ceasing to be a director. However, a defence is that the director can show that they exercised the degree of care, diligence and skill (“due diligence”) required to prevent failure. The provisions are:

Income Tax Act

227.1 (1) Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or 135.1(7) or section 153 or 215, has failed to remit such an amount or has failed to pay an amount of tax for a taxation year as required under Part VII or VIII, the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay that amount and any interest or penalties relating to it.

Excise Tax Act

323. (1) If a corporation fails to remit an amount of net tax as required under subsection 228(2) or (2.3) or to pay an amount as required under section 230.1 that was paid to, or was applied to the liability of, the corporation as a net tax refund, the directors of the corporation at the time the corporation was required to remit or pay, as the case may be, the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay the amount and any interest on, or penalties relating to, the amount.

²⁹⁰ Section 239 Income Tax Act

²⁹¹ Income tax Act 2004

A common scenario in creating director's liability in Canada is when a business is in financial difficulty and it uses taxes collected to continue trading rather than ceasing. However, when the company realises that these funds are insufficient to continue trading, the company goes out of business. CRA has a statutory right to go after the directors.

The purpose and scope of these provisions was considered in *Smith v R.*²⁹². The directors' liability provisions were enacted to strengthen the Crown's ability to enforce statutory obligation imposed on certain taxpayers. Normally the Crown's remedies against a company that fails would be limited to the company's assets. This is as a result of the separate corporate personality

It was perceived that a company in financial difficulty might default in its tax payment obligations in preference to its more immediate needs. It was then seen as necessary to deter companies from making these choices. Consequently, section 227.1²⁹³ and section 323²⁹⁴ were enacted to impose liability, subject to certain conditions, on the directors of the company that failed in its tax payment obligations. But this is based on the assumption that the decision of the company to default on its tax payment obligations originated from the directors.

In *Soper v The Queen*²⁹⁵ it was found that in 1981-82 the company, faced with a choice of paying taxes to the Crown or paying key creditors, whose goods and services were necessary to continue operation of the business, the directors chose the latter action. This abuse and mismanagement on the part of directors constituted the "mischief" at which section 227.1²⁹⁶ was directed

While this research has found no equivalent provision to section HK11²⁹⁷ with the Canadian tax legislation, it is obvious that the Commissioner of CRA has the ability to deal with the mischief of "asset stripping".

²⁹² [2001] 2 C.T.C. 192 (Fed C.A)

²⁹³ Income Tax Act

²⁹⁴ Excise Tax Act

²⁹⁵ [1997] 97 D.T.C. 5407 (Fed C.A)

²⁹⁶ Income Tax Act

²⁹⁷ Income Tax Act 2004

D. Summary

The above overseas jurisdictions do not have specific provisions within the Revenue Acts that allow the Commissioner to penetrate the corporate veil of the company to impute liability onto directors and shareholders for tax debt. These jurisdictions rely on the Companies Act and Insolvency Act remedies.

IX. TAXATION RISK MANAGEMENT

A. Tax Policy & Administration

Tax administration is fundamental to the functioning of the economy. Its role is to ensure that it collects sufficient revenue to meet Government's expenditure objectives and also to obtain a surplus in the budget. Underpinning these objectives is the policy of ensuring that the manner in which the tax system achieves this is both efficient and simple. The New Zealand government strives for a robust tax system comprising both tax law and tax administration.²⁹⁸ This is achieved through the care and management provisions of the Tax Administration Act 1994. Care and management helps maintain the integrity of the tax system.

Tax policy plays an important role in supporting government's goal of fostering an environment of economic growth. In order to achieve economic growth, a country must have an effective and efficient tax system.²⁹⁹ The tax system does not only need to be efficient and effective but simple as well. The most critical aspect of the tax system is the manner in which it is administered. If the system is administered poorly then widespread abuse will reign and its integrity will be undermined. Therefore administering the tax system in an effective and efficient manner will ensure that a robust tax system exists.

The strategy adopted by the administrator (CIR) to achieve this is by encouraging voluntary compliance. Voluntary compliance is a system whereby taxpayers meet all or most of their tax obligations with the intervention of the administrator. This is the same strategy adopted by tax administrators in other jurisdictions such as the Australian Tax Office, United Kingdom Board of Internal Revenue, Revenue Canada and United States Internal Revenue Services. In New Zealand the system appears to be both cost effective and efficient. However, this is only established once a full audit is undertaken because this proves the honesty or otherwise of the taxpayer. Past research has shown that the vast majority of taxpayers do comply

²⁹⁸ <http://executive.govt.nz/96-99/compliance/index.html> Part II, Robustness Against Avoidance and Evasion

²⁹⁹ Inland Revenue, Corporate Insolvency-Taxation Risk Management, speech by CIR, David Butler at the New Zealand Law Society taxation conference on the 6 September 2006, Auckland

with their tax obligations. Given the economic growth of the foreign jurisdictions above, this system would be effective there as well.

In New Zealand, the CIR in performing his duties of administering an efficient and effective tax system operates with limited resources. As a result there are times when choices have to be made about the best use of these resources. Although the primary duty of the CIR is to collect taxes he is constrained by the limited number of resources available to fulfil his duties. As a result the legislators have allowed the CIR discretionary powers under section 6³⁰⁰ and 6A³⁰¹. These provisions allow the CIR to prioritise his duties depending on the availability of resources.

6(1) [Ministers and officials to protect integrity of tax system]

Every Minister and every officer of any government agency having responsibilities under this Act or any other Act in relation to the collection of taxes and other functions under the Inland Revenue Acts are at all times to use their best endeavours to protect the integrity of the tax system.

6A (2) [Care and management of taxes]

The Commissioner is charged with the care and management of the taxes covered by the Inland Revenue Acts and with such other functions as may be conferred on the Commissioner.

6A (3) [Collection of taxes]

In collecting the taxes committed to the Commissioner's charge, and notwithstanding anything in the Inland Revenue Acts, it is the duty of the Commissioner to collect over time the highest net revenue that is practicable within the law having regard to—

- (a) The resources available to the Commissioner; and
- (b) The importance of promoting compliance, especially voluntary compliance, by all taxpayers with the Inland Revenue Acts; and
- (c) The compliance costs incurred by taxpayers.

Furthermore, it must be remembered that even though the CIR is tasked with the duty to collect revenue this is not an absolute duty. This means that the CIR is not expected to collect all tax that is owed by every taxpayer. He is however expected to collect the highest net revenue over time while protecting the integrity of the tax system.³⁰²

176(1) [Commissioner must maximise recovery of outstanding tax]

The Commissioner must maximise the recovery of outstanding tax from a taxpayer.

176(2) [Situations where Commissioner may not recover outstanding tax]

³⁰⁰ Tax Administration Act 1994

³⁰¹ Ibid

³⁰² INS00072[d] CARE AND MANAGEMENT OF TAXES Draft Interpretation Statement, 21 December 2005

Despite subsection (1), the Commissioner may not recover outstanding tax to the extent that—

- (a) Recovery is an inefficient use of the Commissioner's resources; or
- (b) Recovery would place a taxpayer, being a natural person, in serious hardship.

The duty of the CIR to collect the highest net revenue over time is often challenged by taxpayers. But the CIR's duties are not absolute. In recent times a number of cases heard in Court called in question the duties of the CIR.

In *Fairbrother v CIR*³⁰³ the issue was whether the CIR could enter into an agreement with a taxpayer to collect less than the full amount of tax owing if specific remission and relief provisions did not apply. Young J was of the view that the CIR was not under a statutory obligation to collect the correct amount of tax and stated:

“...the legislation under consideration by the house of Lords provided that income tax should be ‘under the care and management of the Commissioners’. There was, however no express statutory provision comparable to the duty now imposed by section 6A on the Commissioner in New Zealand ‘to collect over time the highest net revenue practicable with the law’. Yet the phrase ‘care and management’ was construed as, in effect, imposing such a duty on the Commissioners.”

This case determined that it is possible for the CIR to collect less tax than is owed for debt collection purposes as long as it does not contravene an express statutory provision.

In *Raynel v CIR*³⁰⁴ the issue was whether the CIR was bound to accept a proposed compromise rather than pursue bankruptcy proceedings given less tax would be recovered under the latter action. Randerson J held that the duty to maximise tax was not an absolute one. Accordingly, the CIR was not obliged to accept a compromise where the integrity of the tax system would be served by pursuing legal action.

These cases confirm that the Court is unable to look behind the CIR's use of his statutory discretion as it relates to the care and management of taxes.

³⁰³ [2000] 19 NZTC 15,548

³⁰⁴ [2004] 21 NZTC 18,583

B. Tax Compliance

The preference of the CIR in collecting taxes is not litigation but for taxpayers to pay on their own accord. Hence the CIR promotes voluntary compliance rather than resorting to unnecessary utilisation of limited resources.

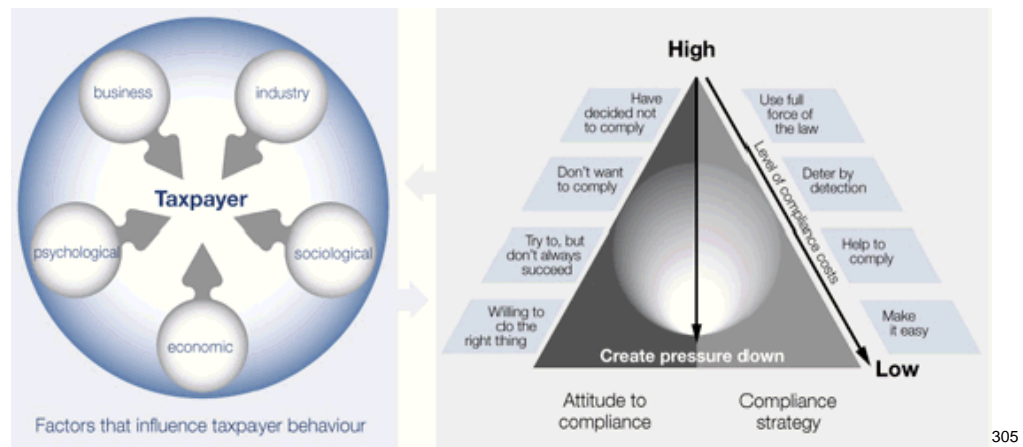
Encouraging voluntary compliance involves making it easy for those who want to comply and at the same time making it very difficult for those who choose not to comply. Those who do not want to comply are also brought to account in an appropriate manner.

It is very important that the tax system is seen as fair and consistent otherwise voluntary compliance will be undermined. Debt collection activities allow the CIR to influence and maintain community confidence, through tailoring enforcement activities that reflect the consequences of non-compliance.

The Compliance Model

In order to ensure that the CIR operates in the most transparent way possible while ensuring that no class of taxpayers is unnecessarily prejudiced, the CIR utilises a compliance model. The compliance model is a framework that helps the CIR to understand those factors that influence taxpayer compliance behaviour. By understanding the factors that influence taxpayer compliance behaviour appropriate action(s) are taken to change that behaviour. The compliance model helps the CIR to tailor his management of taxpayers effectively with a fair and consistent approach.

The compliance model is as follows:



David Butler, Commissioner of Inland Revenue stated³⁰⁶:

“In applying the model we will:

- [A]appropriately enforce the law to help move customers who have decided not to comply to a position where they are likely to do so in future”

The compliance model is used to assess where a taxpayer is situated on the compliance triangle having taken all factors that influence his behaviour. By identifying the type of taxpayer behaviour the CIR is able to ensure the most effective remedy is selected to change that behaviour. It also ensures that the most cost effective remedy is utilised thereby maximising the use of the CIR’s resources.

The strategy is both simple and efficient. Taxpayer confidence in the integrity of the tax system is ensured. This system is also utilised in Australia. But is ‘voluntary compliance’ really voluntary? Surely taxpayers are fully aware that if they fail to comply they will face the legal repercussion of non compliance, especially if they are situated at the top of the compliance model triangle. How then can it be said that the system is based on voluntary compliance? It is not different from any other mandatory law such as criminal law. People behave as the law requires because if they transgress from the law, there are consequences. Taxpayers are likely to engage in a “cost benefit” analysis when deciding whether or not to comply.

³⁰⁵ <http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>

³⁰⁶ In a speech, on *Corporate Insolvency – Taxation Risk Management* at the New Zealand Law Society Taxation Conference, 6 September 2006, Auckland

C. Suggested Reform for Section HK11

a. The Tax Avoidance Issue

The 1988 Government Report on tax Compliance,³⁰⁷ by the Committee of Experts expressed concern over the apparent tension between the requirements of subsection (1)(c)(i) and (1)(c)(ii)³⁰⁸. The committee stated that since the purpose of the arrangement was that the company was unable to satisfy its liability for tax, this amounted to tax avoidance.

The committee stated at paragraph 11.50 -11.51 that;³⁰⁹

The requirement in subsection (1) (c) (ii), that a purpose of the arrangement was to have the effect of tax avoidance, make the tax recovery provision too difficult to apply because it requires the Commissioner to show subjective intent. A court would be unlikely in all but the most blatant circumstance to include that a purpose of the impugned arrangement was to avoid payment of tax. This purpose would have to be foreseen and intended consequences or a goal of the arrangement.

In addition, the second limb of paragraph (c) seems to frustrate the objective comment of the first limb, which sets out the test of a director who made all reasonable enquiries into the company's affairs and what he or she would have anticipated as likely. This first limb seems to be designed to target recklessness, negligence or oversight on the director's part. However, if the directors have not made all reasonable enquiries, and therefore do not know of the looming tax liability, how can they be said to have a purpose of avoiding tax under subsection (1) (c) (ii)? It follows that the second limb would always rule out recklessness, negligence, or oversight.

The committee recommended in its report that the Government amend section HK11³¹⁰ to make the recovery provisions more effective by changing the requirements to an avoidance purpose so that it is an alternate requirement only. The committee believed that amendment was consistent with the policy intent of the tax recovery provision making the requirement for reasonable enquiries by a director the main test for the provision.³¹¹

³⁰⁷ Report to the Treasurer and Minister of revenue by Committee of experts on Tax Compliance December 1998

³⁰⁸ Section HK11 Income Tax Act 1994

³⁰⁹ Report to the Treasurer and Minister of revenue by Committee of experts on Tax Compliance December 1998

³¹⁰ Income tax Act 1994

³¹¹ Report to the Treasurer and Minister of revenue by Committee of experts on Tax Compliance December 1998 paragraph 11.52

To date, no such amendment has been made. Even though the Income tax Act has now been rewritten this part of the provision remains largely untouched. This can only mean that officials believe that HK11³¹² in its current form meets the required policy intent. Given that there are no cases which have addressed the substantive requirements of the application of the provision, it is difficult to agree or disagree with that position.

But it does beg the question of why the CIR is not using this particular recovery provision more. Given the increase in the level of difficult debt reported by Inland Revenue, it cannot be due to the lack of potentially suitable cases. Is it a lack of training of IRD solicitors, a lack of political willpower by IRD management, a lack of resources (e.g. investigators, litigators, funds for briefing Crown solicitors, etc) or a lack of awareness of the issue?

b. The Active Director Issue

The defence for directors is that they will not be liable if the CIR is satisfied that they derived no benefit from the arrangement and have either dissented from the arrangement³¹³ and notified the CIR of the arrangement and their dissent³¹⁴, or they prove to the CIR that they were not involved in the executive management of the company at the relevant time (s)³¹⁵ and they had little or no knowledge of the arrangement.³¹⁶

It is difficult to understand how the “executive management” defence will work in practice. To begin with, directors who notify the CIR, expose themselves, and/or other directors and shareholders, to an enquiry under section HK11³¹⁷. Considering the wide ranging powers of the CIR and the intrusiveness of an IRD audit it is unlikely to be effective to have the director opting for this approach. This defence would appear to be ineffective and therefore would fail to promote voluntary compliance.

³¹² Income Tax Act 2004

³¹³ Section HK11(6)(a)(i) Income Tax Act 2004

³¹⁴ Section HK11(6)(a)(ii) Income Tax Act 2004

³¹⁵ Section HK11(6)(b)(i) Income Tax Act 2004

³¹⁶ Section HK 11(6)(b)(ii) Income Tax Act 2004

³¹⁷ Income Tax Act 2004

Furthermore, there is no guidance on what constitutes “executive management” because the term “executive” is not defined in the Income Tax Act 2004. The dictionary³¹⁸ meaning is as follows:

a person or group responsible for the administration of a project, activity or business

The term “execute” and “management” are defined as follows:

execute...5 to carry into effect (a judicial sentence..)”
“management...1 the members of the executive or administration of an organisation or business 3 the technique, practice, or science of managing, controlling or dealing with...

The dictionary meaning of executive denotes more of an administrative rather than control function, this usually denotes senior management. Therefore “executive management” extends beyond simple administration to making decisions necessary to carry into effect the plans and policy of the company. It means active management in executing the company affairs, although not necessarily on a day to day basis, and certainly implementing decisions made at the board level requiring an involvement with the day to day affairs

Although there is no case law on the term “executive management”, the case law concerning company residency has looked in detail at the terms “administrative management” and “centre of management”. However, these terms are different and have been applied in a different context. Consideration must be given to the involvement and participation rather than the position held by the director. A good analogy, even though frivolous, of involvement and participation is “*likened to that of a bacon and egg breakfast. The chicken is involved, whereas the pig is a participant*”.³¹⁹

The premise that executive management must extend beyond basic administration to both an active involvement and participation is a logical approach otherwise the policy intent of section HK11³²⁰ would be frustrated as it would target a much wider class of directors than intended. It makes sense for the term to mean active management which entails decision making into the day to day affairs of the company.

³¹⁸ Collins English Dictionary, Complete & unabridged, New Edition

³¹⁹ *Thought of the day*, The Breeze, 2 July 2008

³²⁰ Income tax Act 2004

This meaning needs to either be contained within the definitions of this provision or in an operational statement. This clarification will help improve the efficiency of the tax system.

c. The Liquidation Issue

In applying section HK11³²¹, the CIR may issue an assessment or an amended tax assessment in relation to a liquidated company, subject to the four year time bar period, as if the company had not been issued with an assessment or amended assessment.³²² If the CIR is applying this provision to directors of a liquidated company, the CIR must nominate the person or persons whom the CIR considers liable for the tax liability and those persons are treated as agents of the liquidated company for the purposes of this tax liability.³²³

When the CIR seeks to invoke section HK11³²⁴, the status of a liquidated company is a contentious one. This is so due to the tension between the liquidator's duties³²⁵ and his right to object to the application of section HK11³²⁶. The decision in *Spencer & Anor v CIR*³²⁷ has made the CIR gun-shy concerning the use of section HK11³²⁸ as a recovery provision.

In relation to the care and management provisions³²⁹, it is an ineffective use of resources if the application of section HK11³³⁰ fails for procedural reasons. The CIR has an overriding obligation to acknowledge the rights of taxpayers including taxpayers who are deemed agents of other taxpayers who have a tax liability. The CIR should issue a standard practice statement advising how he intends to approach the application of section HK11³³¹.

³²¹ Ibid

³²² Section HK11(7)

³²³ Section HK11(8)

³²⁴ Income Tax Act 2004

³²⁵ Companies Act 1993 and Insolvency Act 1967

³²⁶ Income Tax Act 2004

³²⁷ [2004] 21 NZTC 18,818

³²⁸ Income Tax Act 2004

³²⁹ Section 6 and 6A Tax Administration Act 1994

³³⁰ Income Tax Act 2004

³³¹ Ibid

d. The Objection Issue

Section HK11³³² should be a disputable decision and the disputes process should be an option to the taxpayer.³³³ However, in practice the CIR has used section HK11³³⁴ and advised defence council that the only recourse for defending such claims is Judicial Review in the High Court.

Under the current construction of section HK11³³⁵, David Snelling, author of "*Difficulties in disputing the application of s HK11*" agrees that the CIR can apply the provision in this manner. This means that the taxpayer cannot issue a Notice of Proposed Adjustment to the CIR but may respond via Judicial Review.

However, the author does state that legislative amendment is required since tax administration is not meant to close the door of the disputes process to taxpayers and force them to resort to costly High Court litigation. Statutory interpretation is an issue and the author is accepting that the CIR can apply section HK11³³⁶ as is but that legislative amendment would provide clarity.

The author's argument may be justified given that the CIR the power and delegation to proceed with the current provision as is. But the fact that the "taxman" isn't every taxpayer's favourite creditor may result in lobbying for a cost-efficient way of disputing tax liability if such a case proceeded. Tax practitioners also have a vested interest in preferring the more user friendly disputes process.

The outlook for HK11³³⁷ is uncertain. The CIR can legally rely on the recovery provision in its current form, from a policy perspective of preventing the erosion of the tax base. But, is it advisable to do so? Or is this at odds with the spirit, purpose and goals of the disputes process and more importantly the Inland Revenue Charter? Personally, I think the latter.

³³² Ibid

³³³ CCH New Zealand Ltd, NZ Tax Planning Reports, 2006, No 6, December 2006 Article on *Difficulties in disputing the application of s HK 11* by David Snelling, solicitor, Kensington Swan (Auckland)

³³⁴ Income tax Act 2004

³³⁵ Ibid

³³⁶ Ibid

³³⁷ Ibid

X. SUMMARY AND CONCLUSION

As creditor of a liquidated company the CIR needs to consider his ability to recover unpaid tax. He may consider actions under sections 135³³⁸ and 136³³⁹. When a judge issues a decision on perhaps reckless trading, the judge has to maintain the integrity of the jurisprudence of corporate law and is bound to do so. This implies that the judge wouldn't discriminate against the CIR as a unique status creditor/plaintiff in a corporate litigation matter. This is what already occurs in non-tax remedy matters such as common law remedies like Mareva injunctions.

Section HK11³⁴⁰ provides an alternative route of recovery of unpaid tax from those involved with the liquidated company. This provision is one of several statutory exceptions to the separate legal personality for a company. It is intended to be used to recover outstanding tax debts in certain circumstances from a director of a company when the company is unable to satisfy its tax liability.

It is a recovery provision seldom used by the CIR. In pursuing this course of action the CIR must establish that the company has been stripped of its assets thereby leaving it with the inability to satisfy its tax liability. The focus of enquiry by the CIR is to establish that this has occurred through an arrangement which the potentially liable directors/shareholders had knowledge of or involvement in. The consequence or effect of that arrangement is that the company is unable to pay its tax. The CIR must then link the role played by the director with that of the arrangement. A director's liability depends on his/her level of involvement in the arrangement.

Section HK11³⁴¹ should be considered as an alternate recovery action for the CIR when the facts of the case support its application, notwithstanding that the Companies Act 1993 remedies are also available. With much uncertainty and little judicial guidance on the application of this provision, the CIR should be seeking a test case to allow the Courts to consider the thresholds required for its successful application. Or write a public binding ruling.

³³⁸ Companies Act 1993

³³⁹ Ibid

³⁴⁰ Companies Act 2004

³⁴¹ Income Tax Act 2004

The CIR should not be resisting the use of this section given its potential to maximise tax recoveries in cases where recovery would be minimal or nil. This would also support the care and management duty of the CIR and enhance the integrity of the New Zealand tax system.

If the CIR is not prepared to make use of this provision then the only logical alternative is to have it removed altogether. After all, this would not be detrimental to tax law in New Zealand. As we have seen in other bigger, more efficient economic jurisdictions there is no need for a specific provision such as HK11³⁴². These jurisdictions are still able to efficiently administer the tax system without compromising its integrity. This is despite the fact that these jurisdictions have more company taxpayers and more complex structures to contend with.

Why must the CIR reinvent the wheel to recover debt from a delinquent debtor? The CIR should get in line with other creditors and use proven remedies. This would optimise the use of limited resources as well as send a strong message to those in control of defunct companies. It will uphold the integrity of the tax system as a whole. Here are some reasons why commercial remedies (e.g. Companies Act 1993, Fair Trading Act 1986, etc.) ought to be preferred:

- HK11³⁴³ is beset by legal uncertainty regarding the nature, substance and process for applying it. There is confusion and fundamental differences of opinion about whether HK11³⁴⁴ is a recovery or assessment provision. If Inland Revenue is itself divided on the nature of this remedy and its proper application, how are taxpayers expected to understand it?
- Companies Act 1993 remedies are in line with the imperative for legal harmonisation with our nations trading partners whereas section HK11³⁴⁵ is unique. First, it is better for foreign directors and investors to understand their legal obligations and risk than to have peculiar remedies which are domestically unique. Second, the CIR

³⁴² Ibid

³⁴³ Ibid

³⁴⁴ Ibid

³⁴⁵ Ibid

will benefit from the international legal developments on Companies Act 1993 remedies (under comparable corporate law) whereas with section HK11³⁴⁶ the CIR stands alone bearing the burden and cost of developing the law on section HK11³⁴⁷ remedy. Other countries have already used similar remedies (reckless or fraudulent trading) to recover debts for the Crown thus these remedies accord with best practice.

- At least one other government department in New Zealand (NZ Customs) has used Companies Act 1993 remedies with great success. This trailblazing has proven domestically that Companies Act 1993 remedies have great efficacy for collecting Crown debts. With section HK11³⁴⁸ the CIR stands alone among public departments in using this remedy and developing the law for Crown tax debt recovery.
- If the CIR were to assist in developing and using Companies act 1993 remedies this would have benefit for other domestic creditors - both public and private – thus strengthening the domestic legal environment and economy;
- Companies Act 1993 remedies minimise risk since multiple claims may be included in the same action thus affording the plaintiff better odds of success, whereas section HK11³⁴⁹ is a "one shot" or one claim/cause of action option;
- Companies Act 1993 remedies target multiple goals (e.g. debt recovery; risk management via court banning; etc) whereas section HK11³⁵⁰ only targets debt recovery;

³⁴⁶ Ibid

³⁴⁷ Ibid

³⁴⁸ Ibid

³⁴⁹ Ibid

³⁵⁰ ibid

- Companies Act 1993 remedies cover a very broad array of mischief or unlawful behaviour (e.g. failure to keep accounting records; failure to file tax returns; voidable preferences; etc) whereas section HK11³⁵¹ only targets a narrow field of mischief (i.e. asset-stripping or phoenixing).
- The Inland Revenue employs solicitors who generally bring with them experience using commercial remedies (e.g. Companies Act 1993 claims, Fair Trading Act 1986, torts, etc.) whereas section HK11³⁵² litigation experience is something unique to the Inland Revenue and which each new solicitor would have to learn at the Inland Revenue.

The advantage which the CIR obtains from using non-tax remedies is avoiding the hypersensitive tax policy issues and complications of the tax realm. At a policy level, taxpayers could respond by arguing that the CIR should be limited to using Tax Administration Act 1994 remedies, but this tact is unlikely to succeed.

Finally, my view is that non-tax remedies avoid the pitfalls of tax policy and tax law such as found in section HK11³⁵³.

³⁵¹ Ibid

³⁵² Ibid

³⁵³ Ibid

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