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NEWSLETTER

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Limited Liability - But Not for Directors

The concept of limited liability was a product of the Industrial Revolution, to enable aggregation of capital and thereby, to promote economic growth. It enabled numerous shareholders to invest in an enterprise without risking their wealth beyond the amount that was invested in the company. It is a common misconception that limitation of liability is a concept that applies to directors. But, directors have no limited liability protection and therefore may be personally liable for meeting the demands of company creditors.

The directors of three companies were recently required to pay several millions of dollars to the liquidators of their respective companies. Two of the companies were by order of the Court and the third company settled virtually on the Court's steps. These cases have highlighted both the likelihood of director liability and the potential magnitude of damages that could be awarded. In some cases the Court has been prepared to award damages covering the full shortfall to creditors plus costs. Directors have had little success in the decided cases, although the number of cases since the enactment of the Companies Act 1993 has been relatively low.

A director can be found personally liable for misapplied money or property of the company, or for negligence, default, or breach of duty or trust. Directors must not cause or allow the business of the company to be carried on in a manner that is likely to create a substantial risk of serious loss to the company's creditors. A director must also have reasonable grounds to believe that the company will be able to perform its obligations at the time that they are entered into. Furthermore, directors must exercise the care, diligence and skill of a reasonable director in the same circumstances.

The fundamental determinant of director liability is "reasonableness". Were the steps that the directors took (or neglected to take) reasonable in the circumstances?

What is often overlooked is the right, or indeed obligation, of directors to take on risk in order to produce returns for their shareholders greater than what they can achieve from a risk free investment such as government stock.

While directors are entitled to take commercial risks, they are expected to do so with equity (shareholders' funds), not with creditors' funds. If a company has exhausted its equity, then the commercial risks the directors take are with creditors' funds. Directors usually stand to gain from the upside of these commercial risks, either by virtue of their shareholding or from performance benefits.

Once actual or impending insolvency is identified, directors have a brief window of opportunity to formulate a recovery plan. If the plan is reasonable, the directors may escape personal liability while the plan is implemented. The proviso is that the implementation of the plan must be closely monitored and if targets are not met then steps should be taken to liquidate the company. Failure to do so will probably result in further erosion of the position of creditors.

The need for independent professional advice is critical once potential insolvency is identified.

The concept of limited liability entitles companies to fail without recourse to the owners (shareholders). Where reckless disregard is applied to the position of creditors, then directors cannot expect to escape potential personal liability.

As Priestly J put it in Re Group Hub Limited, "The shield of incorporation will be of no avail to a director on the battlefield of trade if that director knows full well, or ought to have known, that creditors' claims cannot be met or if the shield-carrying director is allowing the company to trade recklessly."

Tax Penalty Tweaks

The Inland Revenue Department (IRD) released a discussion document in 2006 seeking submissions on a range of proposed changes to the shortfall penalty regime. Some of the proposed changes have been included in draft legislation, providing the first glimpse of the changes.

When an incorrect tax position is taken, a penalty on the tax shortfall can be imposed by the IRD. The type of penalty and therefore the amount of the penalty varies based on the circumstances. At the lesser end of the scale of penalties are those relating to either exercising a lack of reasonable care or taking an unacceptable tax position. A penalty of up to 20% of the tax shortfall can apply when these types of penalties are charged.

If a taxpayer, or his or her accountant, identifies an error in a tax return that has been filed, which has resulted in an underpayment of tax, and a voluntary disclosure of the error is made to the IRD, then the IRD is required to consider whether or not shortfall penalties apply. This process was often considered draconian, given that the taxpayer was simply trying to do the right thing by making a voluntary disclosure. If the proposed legislation is passed, a shortfall penalty for exercising a lack of reasonable care or taking an unacceptable tax position will no longer be charged where a voluntary disclosure is made prior to the IRD notifying the taxpayer of an audit. Once passed, the amendments will be retrospective to the date the Bill was introduced.

Another proposed change to the legislation is that from 1 April 2008, the application of the "unacceptable tax position" penalty has been narrowed to only apply to income tax shortfalls, where the tax shortfall is more than $50,000 and more than 1% of the tax figure for the return period.

If the draft legislation is passed without material amendment it will be more conducive for taxpayers to make voluntary disclosures and pay the correct amount of tax without fearing the added burden of shortfall penalties.

Research & Development (R&D) Credits

The proposed R&D tax credit announced in the 2007 budget is not just aimed at businesses that undertake traditional 'white coat' scientific research; the credit could potentially benefit a wide range of businesses. For example, the design and development of a new manufacturing process could qualify.

New Zealand businesses conducting 'eligible' R&D activities predominantly in New Zealand will qualify for a tax credit of 15% on 'eligible' expenditure in a year, providing the businesses have control over the R&D activity; bear the associated technical and financial risk; and own the result of the activities. The R&D credit is on top of the deduction that a business would normally be able to claim on their R&D expenditure - i.e. the credit will not reduce the deduction already available for the R&D. In effect, a business that has deductible R&D expenditure of $100 will have a net cost of $55 after tax and R&D credit.

The wide definition of what constitutes an eligible R&D activity opens the door for a broad range of businesses to benefit from the credit. The draft legislation introduced in the Budget requires an R&D activity to resolve scientific or technological uncertainty, or to involve an appreciable element of novelty. Set out below is a series of questions that a business should ask when considering eligibility:

- Is the outcome uncertain?
- Are the methodologies unknown in advance (i.e. how can we achieve the technical objective)?
- Are the results of the R&D uncertain (i.e. can we achieve the technical objective)?
- Is there a risk of technical failure?

Businesses will also need to comply with requirements to document the R&D process.

Activities that support and are integral to the main R&D activities will also qualify.

Eligible R&D expenditure includes the cost of employee recruitment, training, travel and remuneration, depreciation of tangible assets used primarily in conducting R&D, overheads, and consumables. Ineligible expenditure includes interest costs, expenditure incurred on intangible assets, the write-off or loss of depreciable property, and professional fees incurred in determining a business' eligibility for the credits.

In order to claim the credit, eligible expenditure must exceed $20,000 in an income year, providing the business was eligible for a credit at all times during that year. Businesses that incur less than $20,000 of eligible expenditure can still qualify for the credit providing that they outsource their R&D to a listed research provider that is not associated with the business.

Crown Research Institutes, tertiary institutions, district health boards, their associates and entities controlled by them will be ineligible for the credits where they undertake the R&D activities on their own account.

The credit will be available for software development. However, in-house software development will be subject to a $2million cap unless an application is made to the Minister to waive the cap on the grounds of national interest.

Once enacted, the credit will apply from the 2008/09 income year.

KiwiSaver

Budget 2007 unveiled a number of KiwiSaver surprises that have been met with mixed reactions. What has become a controversial change is the requirement for employers to compulsorily contribute towards their employees' KiwiSaver fund. The employer contribution is to be phased in over a four year period, starting at 1% from 1 April 2008 and increasing by one percent each year, to a maximum of 4%.

The second surprise was the introduction of tax rebates for employees, and tax credits for employers making contributions to KiwiSaver.

The employee rebate came into effect from 1 July 2007. The amount of the rebate is set at the greater of the employee's contribution or $20 per week. Contrary to some initial expectations, the contribution is not paid direct to the employee, but is credited to the employee's KiwiSaver fund once a year.

The employer tax credit is also limited to the greater of the employer's contribution and $20 per week. In effect the employer credit is fully funded by the government in the first year if an employee is earning less than $104,000 per annum. The employer contribution, excluding the tax credit portion, will be a deductible expense. Employees aged between 18 and the age of eligibility where they can withdraw funds from their KiwiSaver scheme are eligible for the employee tax rebate and the compulsory employer contributions.

Currently, contributions made by an employer can count toward an employee's contributions. For example, an employee's required 4% can comprise 2% from the employer and 2% from the employee. From 1 April 2008 an employee who has not received employer contributions in this manner will be required to contribute a minimum of 4%. If an employer had been making contributions on behalf of an employee to meet the minimum 4% contribution rate prior to 1 April 2008, complex transitional rules apply depending on the levels of employee versus employer contributions.

Company Tax Rate Reduction

One of the key features of the 2007 Budget is the proposed reduction in the company tax rate from 33% to 30%, from the 2008 – 09 income year. This change in itself is straight forward, but it requires transitional rules relating to areas such as dividend imputation, provisional tax, qualifying company election tax, branch equivalent memorandum accounts, conduit memorandum accounts and foreign investor tax credits. Of particular interest to most taxpayers will be the impact on imputation credits and provisional tax. Given that the imputation and provisional tax changes will have huge impact, we have outlined the transitional rules below.

The maximum level of imputation credits that can be attached to a dividend is currently governed by the imputation ratio 33/67, which is based on the existing 33% company tax rate. The imputation ratio will change to 30/70, as a result of the company tax rate dropping to 30%. To ensure shareholders are not disadvantaged, the current 33/67 ratio for dividend distributions can continue to be used during the transitional period from the 2008 – 2009 income year until 31 March 2010. Depending on the circumstances, it may be beneficial to distribute sufficient retained earnings by dividend before 31 March 2010, to clear all imputation credits relating to tax payments made before 1 April 2008. Otherwise the situation could arise where there are excess imputation credits in relation to retained earnings under the new imputation ratio. For example, if a company has pre 1 April 2008 imputation credits:

	33/67 ratio	30/70 ratio
Net Dividend	$100	$100
Imputation credits required	$49	$43

Imputation credits not used - $6

The concession allowing the 33/67 ratio to be used till 31 March 2010 does not apply where dividends are paid to another company or a widely held savings vehicle, for example a superannuation scheme.

During the transitional period, a company may choose to impute dividends based on the 33/67 ratio even though the corresponding imputation credit was derived based on the new 30% company tax rate. If this occurs and the imputation credit account goes into debit, a one off transitional 10% penalty will be charged.

A company's provisional tax for a year is typically based on a company's residual income tax (RIT) payable in a prior year multiplied by an uplift percentage (e.g. 105% or 110%). If these percentages were applied to a company's RIT calculated at the 33% rate, when estimating tax payable for a year that is at the lower 30% rate the provisional tax payable will be overstated. Transitional percentages will apply to correctly estimate provisional tax in this situation, as follows:

- If a provisional tax payment for the 2008–09 year is based on the 2007–08 year, the provisional tax payable is 95% of the 2007–08 RIT (as opposed to 105%).
- If a provisional tax payment for the 2008–09 year is based on the 2006–07 year, the provisional tax payable is 100% of the 2006–07 RIT (as opposed to 110%).
- If a provisional tax payment for the 2009–10 year is based on the 2007–08 year, the provisional tax payable is 100% of the 2007–08 RIT.

Snippets

GST & Late Filing Penalties

Draft legislation has been introduced that will allow the IRD to impose late filing penalties in relation to GST periods. If a person accounts for GST on the invoice basis at the time a return is due, the late filing penalty will be $250. If a person accounts for GST on the payments basis at the time a return is due, the late filing penalty will be $50. Once enacted the legislation will apply to GST return periods due after 1 April 2008.

Major Property Developments

Draft legislation has been introduced to fix a long standing problem regarding major land developments or subdivisions. In the past if a major development was carried out for the purpose of deriving rental income or to construct business premises, the profit on the sale of the developed land was arguably taxable. This was an anomalous result as the development was not completed to derive a profit on sale. On completion the asset is clearly of a capital nature. Once enacted major developments completed for business premises or rental purpose will not be taxable on sale. The amendment will extend back to include tax years where such sales have previously been correctly treated as non-taxable in a return that was filed on time. This amendment will ensure that such cases will not be subject to re-opening by IRD.

The Next Round

Later this year the Government is expected to release a discussion document looking at ways to reduce tax compliance costs for small to medium sized businesses. Feedback from businesses has been requested outlining what activities take considerable time and suggestions on how this can be improved.

Hopefully some practical suggestions will arise from the process. It is not surprising that this is an ongoing issue with taxpayers, given the current legislative environment.

If you have any questions about the newsletter items, please contact us, we're here to help