
Client Newsletter

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Liquidation of companies

With the recent spate of financial companies falling over, one wonders whether the laws governing their operations are not regulated enough or whether there are other external reasons. It could well be a combination of both and several other factors – external and internal – but usually creditors are the most likely losers in a liquidation.

Whether it is coincidental or a response to increased bankruptcies, reform relating to insolvency laws is underway and the government is expected to legislate it by December 2007. The main change in this area is the introduction of “voluntary administration” whereby the failing company is put under more skilled management, an independent administrator, with the hope of trading it out of its difficulties and returning more to the company’s creditors than would be the case if liquidated.

The independent administrator can be appointed by the directors, a liquidator, a secured creditor or the court, but only with the creditors’ agreement. Once the administrator is appointed, they take control of the company and its business operations and has 25 working days within which to investigate and decide whether the company is salvageable. At this point, the administrator will meet the creditors and put forward a proposal which the creditors may reject or agree.

It remains to be seen whether the voluntary administration process will work or be more effective than a liquidation because:

- The directors are often reluctant to disclose the

financial difficulties of the company to its creditors until it has deteriorated beyond a point of no return – by which time it may be too late to save the company;

- The administrator’s costs are often high and the creditors may not be willing to meet their costs out of the remaining assets of the company;
- Most of the companies that become insolvent are small or medium enterprises and may not be worth saving by that stage; and
- Creditors may have lost their faith in the company and are unwilling to prolong the inevitability of bankruptcy.

Whereas the new process offers a reasonable alternative to creditors who were otherwise compromised under the Companies Act 1993 procedures, the reality is that it may be too late to pursue the viability of the company.

The onus remains with the directors of the company to spot the financial difficulties at an early stage, make a frank assessment of the company’s position and act accordingly. After all, directors do have a duty to act responsibly.

The new legislation also introduces a new offence for directors who act with intent to defraud creditors or do any thing that causes material loss to any creditor. If convicted, they can be liable to a fine not exceeding \$200,000, or imprisonment for up to 5 years.

Fringe benefit tax and cars

It's been over a year since fringe benefit tax (FBT) was imposed on cars leased by a company from a shareholder for use during business hours (popularly known as 9-5 leases or flip-flop leases).

For FBT paid on an annual basis, the value of fringe benefit for cars is calculated as follows:

$$\text{Cost of Car} \times 20\% \times \text{no. of days available for private use per annum} / 365.$$

The cost of the car used in the above formula is the original cost inclusive of GST which means that taxpayers are stuck with the same FBT cost each year until the car is disposed, presuming the availability of the car for private use remains the same, despite the fact that motor vehicles depreciate rapidly each year.

This may have contributed to the proliferation of the 9-5 leases where a shareholder-employee is able to claim the bulk of the running costs and depreciation without their company having to pay FBT. The extra administration costs that came with it are probably not significant when compared with the FBT costs paid annually.

However, this loophole was closed on 1 April 2006 when the government introduced the new FBT legislation. With the FBT imposition on 9-5 leases, another method of calculating FBT was also introduced, which means organisations now have a choice.

Previously, entities providing cars as fringe benefits had no choice but to use only one method based on the original cost in calculating the tax payable on the value of benefit. The new method allows the use of the annual tax book value of the car instead of the cost of the car in the FBT formula; but, it also increases the annual 20% rate to 36%.

Although companies now have a choice of using another method of calculating FBT, the use of a higher rate ensures that the cumulative FBT costs in the first few years' of the purchase of the car using the new method are very similar to the FBT costs

using the old method. It, no doubt, will see the demise of 9-5 leases as we know.

A few points to note –

- If the company has owned a car for five years, it is able to switch to the new tax book value method from the fifth anniversary date of the purchase of the car.
- Under the new method, the minimum tax book value of the car that a company is allowed to use for FBT purposes is \$8,333. This means that even when the car eventually depreciates to below \$8,333, the tax book value is capped for FBT calculations.
- If a shareholder-employee prefers trading-in his high-value car every few years, the company may be better off using the old cost method. However, there are several factors influencing the choice of method used and we recommend you seek professional advice.
- To avoid compliance costs, one may want to make employee contributions that equal the same amount as the value of the fringe benefit thus reducing the fringe benefit to nil. GST will still need to be accounted for in each GST return following the FBT reimbursements. Nil FBT returns can then be filed until the IRD deletes the entity from its FBT database and stops sending FBT returns. The downside of doing this is that if the shareholder does not have a large enough credit balance in his current account, the fringe benefit debits could push their current account into an overdrawn balance.
- The FBT regime, in allowing 100% tax deduction for all private running, is a good foil against the costs of FBT if a car with a modest price tag is used substantially for private purposes.

In conclusion, the FBT regime has become more complex than when it was first introduced and one has to take into consideration a number of factors to weigh the costs against benefits of FBT. We advise you obtain expert advice before purchasing your next vehicle.

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