
CREDIT ISSUES

WOODGATE & CO.

Chartered Accountant

MARCH 2004

INSOLVENCY UPDATE

Breach of agreement with the Australian Taxation Office

In *Deputy Commissioner of Taxation v Moss*, the Victorian Supreme Court was asked to consider the effects of contravention of an agreement reached with the Australian Taxation Office ("ATO").

A company with a \$253,000 group tax liability had entered into a repayment agreement pursuant to Section 222ALA of the *Income Tax Assessment Act 1936* (Cth.) ("the Act"). The company had not made a single repayment. The ATO then took action against the director pursuant to Section 222AQA of the Act, which imposes personal liability upon any person who is a director between the date of the agreement and the date of the contravention.

The director argued that at the time that the company had entered into the agreement he did in fact have reasonable grounds to expect that the company would be able to meet the repayments. He formed this expectation, in light of the company's intention to purchase a business using funding to be provided by the company's bank.

The Court noted several factors relevant to an assessment of whether that expectation was reasonable:

- the company had not traded for twelve months;
- cashflow was insufficient to meet the repayment unless the proposed sale proceeded quickly;
- the bank funding offer was conditional, and did not cover the full purchase price of the business, which remained partly unfunded;
- neither the director nor the proposed borrowing entity had any experience in the industry; and,
- there was no evidence to suggest that there had been an analysis to prove that the business would generate sufficient cashflow to meet bank repayments and pay the instalments to the ATO.

The Court concluded that the director had not provided sufficient evidence that his conclusion was in fact reasonable, and ordered that he be personally liable for the amount of the debt.

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Breach of Agreement II

Deputy Commissioner of Taxation v Simpson also dealt with the consequences of breach of a repayment agreement entered into pursuant to Section 222ALA of the Act.

When the taxpayer failed to comply with the repayment agreement, the ATO took action claiming that the breach of the agreement rendered the director personally liable, and applied for summary judgement.

After the Queensland District Court rejected the summary application, the ATO amended the statement of claim to raise a new cause of action claiming personal liability due to the original failure to remit the group tax and again sought summary judgement.

The director claimed one of the statutory defences, claiming that he had taken all reasonable steps to ensure that he complied with his obligations to remit the group tax. The director argued that accounting, financial, and compliance matters had been delegated to another director with appropriate skills and training, and that he had relied upon the other director to ensure that the company had complied.

The Queensland District Court ruled that:

- the director was actually a signatory to the company's bank account;
- a review of accounting records showed that the director was clearly involved in authorising ongoing financial commitments of the company; and,
- in light of that involvement in financial matters, the director was clearly

obliged to ensure that the company was able to meet its financial commitments.

The Court held that the director had no real prospect of defending the action, and ordered summary judgement in favour of the ATO.

Payment of sales tax a preference

The Liquidator of a company investigated a series of eight payments totalling more than \$8 million made to the Australian Taxation Office, and concluded that they were unfair preferences pursuant to Section 588FA of the Corporations Act.

The ATO argued that the taxpayer company had operated for more than 20 years without any difficulty in paying its sales tax debts. It was true that the company had advised of a temporary cashflow problem and sought an extension of time. The ATO argued this was indicative of a solvent debtor acting responsibly, and did not give rise to suspicions of insolvency.

The Liquidator accepted that the ATO staff may not have suspected insolvency, but claimed that a 'reasonable person' should have concluded that the company was insolvent. The Liquidator argued that:

- information that sales had halved should have given rise to suspicions of insolvency;
- the ATO internal procedures manual appeared to assume that a taxpayer was insolvent before it could agree to an extension of time; and,
- the income tax return submitted by the company, if accessed by the

sales tax staff, would have revealed a large net loss, and significant working capital deficiency and accumulated losses.

In *Cussen & Anor v Commissioner of Taxation* the New South Wales Supreme Court ruled that:

- although the reduction in sales was significant, the Court had to assess the whole picture. In this case, the company appeared to have encountered short term liquidity difficulties and, at the time, appeared to have successfully traded through them;
- even if the ATO procedures manual did require an assumption that a taxpayer was insolvent, a doubtful conclusion in any event, that was irrelevant because the test of reasonableness was applied to a hypothetical 'average business person'; and,
- the company tax return did not provide any current financial information, and certainly did not provide information about the company's cashflow position. In addition there was no evidence of any policy that such information be shared across the relevant departments.

The Liquidator's application was unsuccessful.

Who paid the preferences

As part of a re-financing arrangement, a corporate group arranged the sale of the operating business from one group company to another newly incorporated company in the same group. The sale contract also assigned the vendor

company's book debts to the purchaser and obligated the purchaser to assume some of the vendor's liabilities.

One creditor was not happy with this arrangement and served a statutory demand on the purchaser. The creditor did not pursue a winding up application, but instead negotiated an arrangement that resulted in the purchaser executing a deed that documented its irrevocable undertaking to pay the debt to the creditor.

The vendor company was later wound up. The Liquidator formed the view that five payments totalling approximately \$229,946 made to the creditor were unfair preferences.

The creditor argued that the Liquidator's analysis of insolvency was incorrect because he had disregarded the purchaser's right of contribution from the vendor. The creditor also claimed that the vendor was not a party to the relevant transactions, and that the payments were made to discharge the purchaser's liability rather than the vendor's liability.

In *Jonas v Rocklea Spinning Mills* the Victorian Supreme Court ruled that:

- a right of contribution was not a readily realisable asset and so should be ignored for the purpose of assessing insolvency;
- the relevant transaction could not include the sale agreement (because the creditor was not a party to it) but did include the renegotiation deed; and,
- two of the payments made from the vendor's bank account, albeit as a result of an advance from the

purchaser to the vendor, constituted
unfair preferences and were
recoverable by the Liquidator.

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