

IN THE SUPREME COURT OF NEW ZEALAND

SC 118/2013
[2014] NZSC 160

BETWEEN JENNINGS ROADFREIGHT LIMITED
(IN LIQUIDATION)
First Appellant

BORIS VAN DELDEN AND ROY
HORROCKS AS LIQUIDATORS OF
JENNINGS ROADFREIGHT LIMITED
(IN LIQUIDATION)
Second Appellants

AND COMMISSIONER OF INLAND
REVENUE
Respondent

Hearing: 10 June 2014

Court: Elias CJ, McGrath, William Young, Glazebrook and Arnold JJ

Counsel: A W Johnson and C C Mansell for Appellants
P W O'Regan and P H Courtney for Respondent

Judgment: 7 November 2014

JUDGMENT OF THE COURT

- A The appeal is allowed. The respondent must repay \$14,076.38 to the appellants.**
- B Costs of \$25,000 plus reasonable disbursements (to be set by the Registrar if necessary) are awarded to the appellants.**
-

REASONS

(Given by Glazebrook J)

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Introduction

[1] Jennings Roadfreight Ltd (Jennings) was placed into liquidation on 24 March 2011. At that time, it owed approximately \$50,000 in PAYE for the month ended 28 February 2011. The due dates for payments of the PAYE were 20 February and 5 March 2011.

[2] This appeal concerns \$14,076.38 held in Jennings' bank account at the time Jennings was placed in liquidation.¹ After liquidation, the bank paid the funds to the Commissioner of Inland Revenue.

[3] The liquidators of Jennings made applications, under ss 251 and 292 of the Companies Act 1993, to recover the funds from the Commissioner. They were

¹ The \$14,076.38 was part of a total of \$26,777.80 deducted by Jennings' bank (the Bank of New Zealand) from Jennings' bank account and placed into a suspense account after the bank had received a notice from the Commissioner under s 157 of the Tax Administration Act 1994.

successful in the High Court.² That decision was overruled by a majority in the Court of Appeal (Wild and White JJ), with Ellen France J dissenting.³

[4] The majority of the Court of Appeal held that, under s 167(1) of the Tax Administration Act 1994, any credit balance in Jennings' bank accounts at the time of liquidation was held in trust for the Commissioner.⁴ As such, it did not form part of Jennings' estate in liquidation and therefore did not need to be refunded by the Commissioner.⁵ The majority held that the remainder of the PAYE (of \$35,813.52) ranked, in terms of s 167(2)(b), in accordance with the priorities set out in sch 7 of the Companies Act.⁶

[5] On 14 February 2014, this Court granted leave to appeal on whether:⁷

- (a) the trust arising under s 167(1) of the Tax Administration Act continues in existence upon the liquidation of a company, in respect of funds held in the company's account; or
- (b) the trust is extinguished upon the liquidation, so that the funds held are dealt with in accordance with sch 7 of the Companies Act.

Issues

[6] This appeal therefore concerns:

- (a) the relationship between s 167(1) and (2) of the Tax Administration Act; and
- (b) the nature of the "trust" created by s 167(1).

² *Jennings Roadfreight Ltd (in liq) v Commissioner of Inland Revenue* [2012] NZHC 1441, (2012) 11 NZCLC 98–007 (Associate Judge Doogue) [*Jennings* (HC)]. Two matters in the original judgment were amended by a supplementary judgment: see *Jennings Roadfreight Ltd (in liq) v Commissioner of Inland Revenue (No 2)* [2012] NZHC 1681, (2012) 11 NZCLC 98–008 (Associate Judge Doogue).

³ *Commissioner of Inland Revenue v Jennings Roadfreight Ltd (in liq)* [2013] NZCA 455, [2014] 2 NZLR 569 [*Jennings* (CA)].

⁴ At [20]–[23].

⁵ At [24].

⁶ At [26].

⁷ *Jennings Roadfreight Ltd (in liq) v Commissioner of Inland Revenue* [2014] NZSC 2, (2014) 26 NZTC 21–062.

[7] There had been a cross appeal in the Court of Appeal relating to the effect of s 157 of the Tax Administration Act in the circumstances of this case. This issue was not decided by the Court of Appeal, given the conclusion of the majority on the appeal.⁸ Mr O'Regan, counsel for the Commissioner, confirmed at the hearing in this Court that the Commissioner did not seek to rely on s 157 in this appeal. It is therefore not necessary for us to consider the effect of the bank's actions in placing sums in a suspense account before liquidation.

[8] We deal with each of the issues set out above at [6] in turn, after setting out the relevant parts of the legislative provisions.

The legislation

[9] Section 4A(2) of the Tax Administration Act provides:

- (2) For the purposes of this Act—
 - ...
 - (b) an amount of tax is deemed to be withheld when payment is made of the net amount of a PAYE income payment:
 - ...
 - (c) the amount withheld or deducted described in paragraph (b) ... is deemed to have been applied for a purpose other than in payment to the Commissioner if the amount is not paid to the Commissioner by the relevant due date:
 - ...

[10] Section 167 of the Tax Administration Act provides:

167 Recovery of tax and payments from employers or PAYE intermediaries

- (1) Every amount of tax or combined tax and earner-related payment withheld or deducted under the PAYE rules ... shall be held in trust for the Crown, and any amount so held in trust shall not be property of the employer liable to execution, and, in the event of the bankruptcy or liquidation of the employer or of an assignment for the benefit of the employer's creditors, shall remain apart, and form no part of the estate in bankruptcy, liquidation, or assignment.

⁸ *Jennings (CA)*, above n 3, at [57] per Wild and White JJ and at [79] per Ellen France J.

- (2) When an amount of tax or combined tax and earner-related payment has been withheld or deducted under the PAYE rules ... and the employer has failed to deal with the amount of the tax or payment withheld or deducted (or any part of it) in the manner required by subsection (1) or the PAYE rules, the amount of the tax or payment for the time being unpaid to the Commissioner shall, in the application of the assets of the employer, rank as follows:
- (a) where the employer is, or one of whom is, an individual, upon the employer's bankruptcy or upon the employer's making an assignment for the benefit of the employer's creditors, the amount of the tax or payment shall rank without limitation in amount, and notwithstanding anything in any other Act, in order of priority immediately after preferential claims for wages or other sums payable to or on account of any servant or worker or apprentice or artied clerk, and in priority to all other claims:
 - (b) where the employer is a company, upon the liquidation of the company, the amount of the tax or payment shall have the ranking provided for in Schedule 7 of the Companies Act 1993 (whether or not the company has been incorporated or registered under that Act); and
 - (c) where the employer is a company, upon the appointment of a receiver on behalf of the holder of any debenture given by the company secured by a charge over any property of the company, or upon possession being taken on behalf of the debenture holder of the property, the amount of the tax or payment shall have the ranking provided for in Schedule 7 of the Companies Act 1993 (whether or not the company has been incorporated or registered under that Act), as if the receiver were a liquidator.

...

[11] Section 169 of the Tax Administration Act provides:

169 Unpaid tax payments, etc, to constitute charge on employer's or PAYE intermediary's property

- (1) Where an employer fails wholly or in part to withhold or deduct an amount of tax or combined tax and earner-related payment in accordance with the employer's obligations under the PAYE rules ... or is liable to pay any sum to the Commissioner under the PAYE rules ... an amount equal to the total for the time being unpaid to the Commissioner in respect of that tax, payment, or sum, (including any late payment penalty or shortfall penalty), and in respect of any judgment obtained for that tax, payment, or sum, (including any costs, fees, or expenses included in the judgment or otherwise payable by the employer to the Commissioner in respect of the judgment) shall be a charge on all the real and personal property of the employer.

...

- (2) Every charge created by this section shall be subject to all mortgages, charges, or encumbrances existing at the time of the creation of the charge, but, subject to this section, shall have priority over all other mortgages, charges, or encumbrances. Notwithstanding anything in any other Act, if any property subject to the charge created by this section is also subject to a charge created by that other Act, the charges shall rank equally with each other unless by virtue of that Act the charge so created would be deferred to the charge created by this section.

...

- (10) This section shall apply subject to section 167.

[12] The relevant provisions in sch 7 of the Companies Act provide:

1 Priority of payments to preferential creditors

- (1) The liquidator must first pay, in the order of priority in which they are listed,—

- (a) the fees and expenses properly incurred by the liquidator in carrying out the duties and exercising the powers of the liquidator, and the remuneration of the liquidator[.]

...

- (2) After paying the claims referred to in subclause (1), the liquidator must next pay, to the extent that they remain unpaid, the following claims:

- (a) subject to clause 3(1), all wages or salary of any employee, whether or not earned wholly or in part by way of commission, and whether payable for time or for piece work, in respect of services provided to the company during the 4 months before the commencement of the liquidation[.]

...

- (5) After paying the claims referred to in subclause (4), the liquidator must next pay, to the extent that it remains unpaid to the Commissioner of Inland Revenue or to the Collector of Customs, as the case may require, the amount of—

...

- (b) tax deductions made by the company under the PAYE rules of the Income Tax Act 2007[.]

...

3 Provisions concerning preferential payments to employees

- (1) The total sum to which priority is to be given under any, or all, of paragraphs (a) to (e) of clause 1(2) must not, in the case of any one employee, exceed \$18,700⁹ or any greater amount that is prescribed under subclause (2) at the commencement of the liquidation.

...

The relationship between s 167(1) and (2)

[13] The relationship between s 167(1) and (2) of the Tax Administration Act is not straightforward. There is potential for conflict between the two subsections as both purport to apply in the event of bankruptcy, liquidation or assignment for the benefit of creditors.

The parties' submissions

[14] Jennings submits that any s 167(1) trust is extinguished if the PAYE rules have not been complied with and, in any event, upon liquidation by virtue of s 167(2).

[15] The Commissioner submits that s 167(1) creates a statutory trust to protect the amount of any PAYE deduction (or deemed deduction under s 4A(2)(b) of the Tax Administration Act). If, at liquidation, there is a credit balance in a company's bank accounts then the Commissioner is entitled to it because of the statutory trust. It is submitted that s 167(2) only applies to assets other than the credit balance in the bank accounts.

The statutory wording

[16] Section 167(1) states that all PAYE amounts¹⁰ withheld "shall be held in trust for the Crown" and, in the event of bankruptcy, liquidation or an assignment for the benefit of creditors "shall remain apart, and form no part of the estate" in bankruptcy, liquidation or assignment.

⁹ This figure was changed in 2012 to \$20,340: Companies (Maximum Priority Amount) Order 2012 (SR 2012/252), cl 3.

¹⁰ We refer only to PAYE even though s 167 applies more widely to other deductions, such as those provided for in s 221 of the Accident Compensation Act 2001.

[17] Section 167(2) applies (for companies) upon liquidation or receivership and deals with the priorities if those events occur. The priorities are provided for under sch 7 of the Companies Act.

[18] Section 167(1) is a general subsection and applies even where there is no question of insolvency. By contrast, s 167(2) is a specific subsection, dealing with priorities in an insolvency or receivership situation.

[19] In our view, s 167(2) must be read as a specific qualification of s 167(1) in the circumstances where s 167(2) applies. This means that, in cases where it applies, the specific s 167(2) will prevail over the general s 167(1).

[20] So when does s 167(2) apply? Section 167(2) applies, on the liquidation of a company, to unpaid PAYE in two situations:

- (a) where an amount of PAYE has been withheld or deducted and the employer has failed to deal with the amount of the tax or payment withheld or deducted (or any part of it) in the manner required by s 167(1); or
- (b) the employer has failed to deal with the amount or payment withheld or deducted (or any part of it) as required by the PAYE rules.

[21] Section 167(2) goes on to say that “the amount of the tax or payment for the time being unpaid to the Commissioner” ranks, in the application of the assets of the employer, in the ranking provided for in sch 7 of the Companies Act. Under cl 1(2) of that Schedule, wages and salary and related items rank ahead of unpaid PAYE, which is dealt with under cl 1(5)(b) of the Schedule.¹¹

[22] The first situation, therefore, under s 167(2)(b),¹² is where the employer has

¹¹ Set out above at [12]. The majority of the Court of Appeal, in discussing the Commissioner’s priority for PAYE, cited the Companies Act 1993, sch 7 cl 1(2)(d): *Jennings* (CA), above n 3, at [14]. The Court of Appeal erred. The applicable clause is cl 1(5)(b). Schedule 7 cl 1(2)(d) deals with specific deductions such as child support payments made from the employee, whereas cl 1(5)(b) deals with general PAYE deductions made by the employer.

¹² For convenience from now on, we will refer only to liquidation of a company (under s 167(b)) as that is at issue in this case.

failed to deal with the amount of tax withheld in the manner required by s 167(1). The wording implies that the employer is required to take positive action in relation to sums by holding those amounts in a separate account. The courts, however, have held, with regard to s 167(1) and its predecessor provisions, that there is no such requirement.¹³

[23] We see no reason to depart from the long established reading of s 167(1) to construe it as requiring funds to be segregated.¹⁴ It is unlikely that many businesses would in practice segregate the funds.¹⁵ In light of this, it may be that the words have to be interpreted to mean that s 167(2) does not apply to PAYE that has been withheld in a case where, despite there being no obligation to do so, it has been held separately from other funds. However, it is unnecessary for us to decide this¹⁶ as the funds in this case were not kept by Jennings in a separate account.¹⁷

[24] The second situation under s 167(2)(b), where the amount has not been dealt with as required by the PAYE rules, is straightforward. The PAYE rules require amounts withheld to be paid to the Commissioner on the due date.¹⁸ In this case, payments were not made on the due dates and the amounts remained outstanding as at the date of liquidation. Thus the priorities in s 167(2) apply to Jennings' overdue but unpaid PAYE deductions.

¹³ *Commissioner of Inland Revenue v J F McCormick Ltd* [1964] NZLR 56 (SC) at 59; *Re Westmoreland Box Co Ltd (in liq), Crawshaw v Commissioner of Inland Revenue* [1968] NZLR 826 (CA) at 842 per North P (Turner and Richmond JJ issued separate judgments also dismissing the appeal); and *Commissioner of Inland Revenue v Smith* [2000] 2 NZLR 147 (CA) at [11].

¹⁴ We note that the subsection was re-enacted without a change to the wording after *McCormick*, above n 13: see s 42 of the Land and Income Tax Amendment (No 2) Act 1968. That Act did not disturb s 31(1) of the Income Tax Assessment Act 1957. Instead, the Act repealed and replaced s 31(2).

¹⁵ As recognised in *Re Westmoreland Box Co*, above n 13, at 842 per North P; and *Commissioner of Inland Revenue v Smith*, above n 13, at [11].

¹⁶ This point was also left open by the Court of Appeal in *Commissioner of Inland Revenue v Smith*, above n 13, at [13]. We also do not need to decide if it makes a difference whether the amount was set aside at the time of making the deduction or subsequently.

¹⁷ As noted above at [7], the Commissioner does not seek to rely on s 157 and the fact the funds were placed in a suspense account before liquidation.

¹⁸ See Income Tax Act 2007, ss RD 2 (defining the PAYE rules) and RD 4 (regarding the due dates).

The caselaw

[25] Our view of the role of s 167(2) accords with the observations of North P in *Re Westmoreland Box Co* (as Ellen France J recognised in her dissenting judgment in this case).¹⁹ North P, while recognising the possibility that the draftsman intended that the Crown may be entitled in equity to a first charge on all moneys lying in the company's bank account, went on to say:²⁰

... I am inclined to agree with the Solicitor-General that whatever the intention of the draftsman may have been the provisions of s 31(2) [the equivalent of s 167(2)] are against the view that unpaid tax deductions as such are trust property.

[26] Our interpretation of the relationship between s 167(1) and (2) is also consistent with that reached by the Court of Appeal in *Commissioner of Inland Revenue v Smith*.²¹ The Court in *Smith* said that the s 167(1) trust comes to an end on liquidation by virtue of s 167(2).²²

The scheme of the statutory provisions

[27] The interpretation adopted above, namely that s 167(2) should be seen as a qualification on the general nature of s 167(1), is supported by the legislative scheme.

[28] Section 167 of the Tax Administration Act is part of a body of provisions that deal with the issue of insolvency and how assets are to be distributed to creditors. Schedule 7 of the Companies Act deals with the ranking of preferential creditors upon a company's liquidation. Claims by employees for their wages or salaries, holiday pay and redundancy compensation²³ rank ahead of the Commissioner's claims for GST, PAYE deductions, and resident and non-resident withholding tax deductions.²⁴

¹⁹ *Jennings (CA)*, above n 3, at [69].

²⁰ *Re Westmoreland Box Co*, above n 13, at 842.

²¹ *Commissioner of Inland Revenue v Smith*, above n 13.

²² At [13].

²³ See Companies Act, sch 7 cl 1(2)(a), (b) and (c).

²⁴ See sch 7 cl 1(5). Specific deductions made by the company from the wages or salary of an employee in order to satisfy obligations of the employee (such as child support payments and student loan payments) rank equally with employees' claims under sch 7 cl 1(2) by virtue of sch 7 cl 2(1)(a). See n 11 above.

[29] The Commissioner's proposed interpretation of s 167(1), which would have any credit balance in a company's bank account (up to the amount representing PAYE deductions prior to liquidation) classified as trust property and thus not subject to distribution to creditors, cuts right across the express order of priorities set by Parliament in sch 7 of the Companies Act. Such an interpretation would allow the Commissioner effectively to 'leapfrog' ahead of the other preferential creditors when in fact his or her claims rank below.

[30] This would be contrary to the scheme of the legislation. The clear purpose of s 167(2) was for unpaid PAYE to be subject to the priorities set out in sch 7 of the Companies Act. Other preferential claims, including employees' claims for wages, are to rank ahead of the Commissioner's claim for PAYE upon a company's liquidation.²⁵

[31] In addition, sch 7 of the Companies Act ranks amounts deducted from the wages or salary of an employee in order to satisfy the obligations of the employee (such as child support obligations and student loan repayment obligations)²⁶ above that of PAYE deducted by the employer.²⁷ If a wide interpretation of s 167(1) is given, which means the Commissioner has first access to the credit balance in bank accounts for PAYE deductions by virtue of it being trust property, then the order of priorities in sch 7 with respect to the two types of deductions is effectively reversed, contrary to the order of priorities set out by Parliament in sch 7.²⁸

²⁵ The Commissioner argued that the deductions under s 167(1) are not the employer's, but rather belong to the employees. Employees, however, have no entitlement to receipt of PAYE deductions, which are held for the purpose of paying the Commissioner. However, even if PAYE deductions can be seen as the employees' money, unpaid PAYE takes lower priority than the wages and salaries owed to employees.

²⁶ Companies Act, sch 7 cl 1(2)(d).

²⁷ Schedule 7 cl 1(5)(b).

²⁸ There were also submissions on the charge provided for in s 169(1) of the Tax Administration Act and whether it affects the interpretation of s 167. We do not see the charge under s 169(1) as affecting s 167. This is expressly recognised by s 169(10) which provides that s 169 applies subject to s 167.

The legislative history

[32] PAYE was introduced in 1957.²⁹ Before then, withholding provisions existed but seem to have been of comparatively little moment. These sections were s 31 of the Employment Promotion Act 1936 and ss 118 and 119 of the Social Security Act 1938. Both these Acts required the employer to deduct a charge (a tax) from an employee's salary or wages.

[33] Under those early provisions, to the extent that amounts deducted were not represented by employment³⁰ or social security stamps,³¹ they were deemed to be held in trust.³² The provisions then provided that, to the extent the amounts deducted were not held so as to be "distinguishable" from other moneys held by the employer, they would constitute a charge on all the real and personal property of the employer.³³ That charge had priority over all existing and subsequent charges.³⁴

[34] These early provisions thus appear to have been drafted on the basis that, to the extent moneys were not kept distinguishable from the employer's other moneys (in which case they were held in a trust), they would be subject to a charge but such charge was to have priority over all existing and subsequent charges.³⁵ As a result, regardless of how the deductions were dealt with, the Crown had first claim to the money either through the trust or through an ultimate charge.

[35] PAYE was introduced in 1957 by the Income Tax Assessment Act 1957, which essentially re-enacted the trust provisions in the previous legislation. However, there were three significant differences. First, s 31(1) of the Income Tax Assessment Act included the following words not found in the provisions of the earlier Acts: "and any amount so held in trust shall not be the property of the employer liable to execution, and, in the event of the bankruptcy or liquidation of the

²⁹ Income Tax Assessment Act 1957. Part II of the Act dealt with tax deductions by employers from salary, wages and other source deduction payments.

³⁰ Employment Promotion Act 1936, s 31(1).

³¹ These were stamps created for the sole purpose of employment tax and social security tax: Employment Promotion Act, s 28(1); and Social Security Act 1938, s 128(1). These stamps could be purchased and affixed to wage sheets to pay for the tax required to be deducted by the employer: Employment Promotion Act 1936, s 31(1); and Social Security Act 1938, s 118(1).

³² Employment Promotion Act, s 31(2); and Social Security Act, s 118(6).

³³ Employment Promotion Act, s 31(5); and Social Security Act, s 119(4).

³⁴ Employment Promotion Act, s 31(6); and Social Security Act, s 119(5).

³⁵ Employment Promotion Act, s 31(6); and Social Security Act, s 119(5).

employer or of an assignment for the benefit of the employer's creditors, shall remain apart".³⁶ Secondly, the new Income Tax Assessment Act made no reference to the situation where the wages were not held in a manner "distinguishable" from other money held by the employer.³⁷ In addition, a new subsection was added as s 31(2):

Where a tax deduction has been made under this Part of this Act and the employer has failed to deal with the amount of the tax deduction [in accordance with the Act] ... the amount of the tax deduction for the time being unpaid to the Commissioner shall, in the application of the assets of the employer upon the bankruptcy or liquidation ... rank, without limitation in amount and notwithstanding anything in any other Act, in order of priority immediately after preferential claims for wages or other sums payable to or on account of any servant or worker or apprentice or artied clerk, and in priority to all other claims.

[36] Under s 32(1) of the Income Tax Assessment Act, where the employer failed to deal with the tax deductions in accordance with the Act or had failed to pay those deductions to the Commissioner, as under the predecessor provisions, there was a charge over all real and personal property in relation to tax deductions. But, unlike with the predecessor provisions, this charge did not have priority over existing charges.³⁸

[37] At the second reading of the Income Tax Assessment Bill, the Minister of Finance and Minister in Charge of the Inland Revenue Department, the Hon Jack Watts, said:³⁹

Clause 31 deals with the recovery of tax deductions from employers. The tax deductions made by an employer are of course from money belonging to the employee, not to the employer. They are to discharge the tax liability of the employee to the Crown. This clause therefore provides that tax deductions made by an employer will be held in trust for the Crown. They will not be property of the employer liable to execution, and will not form part of his estate in bankruptcy or liquidation. Subclause (2) of this clause provides that if an employer has misapplied tax deductions they will rank in

³⁶ The same words are now found in s 167(1) of the Tax Administration Act, with only one minor variation.

³⁷ In addition to those main differences, the old Acts said the money was "deemed to be held in trust for the Crown" and the Income Tax Assessment Act 1957 said the money "shall be held in trust for the Crown". Although this change in wording could have been seen as a requirement to segregate the PAYE deductions, this has not been the interpretation given. The courts have consistently held that segregation is not required: see above at [22] and n 13.

³⁸ Income Tax Assessment Act, s 31(2). Subject to the Act, the charge had priority over subsequent charges.

³⁹ (8 October 1957) 314 NZPD 2900.

preferential claims for wages in the event of bankruptcy. Clause 32 provides that the tax deductions which an employer fails to make, or for which he fails to account, shall be a charge on the real and personal property of the employer. That is a machinery clause which is self-explanatory.

[38] In 1968, s 31(2) of the Income Tax Assessment Act was amended and replaced by s 42 of the Land and Income Tax Amendment (No 2) Act 1968. The new s 31(2) provided:

(2) Where a tax deduction has been made under this Part of this Act and the employer has failed to deal with the amount of tax deduction or any part thereof in the manner required by subsection (1) of this section or the other provisions of this Part of this Act, the amount of the tax deduction for the time being unpaid to the Commissioner shall, in the application of the assets of the employer, rank as follows:

...

(b) Where the employer is a company, upon the liquidation of the company or upon the appointment of a receiver ... the amount of the tax deduction shall rank immediately after the debts referred to in subsection (1) of section 308 of the Companies Act 1955 ... it shall have priority over the claims of holders of debentures under any floating charge created by the company and be paid accordingly out of any property comprised in or subject to that charge.

[39] This amendment followed the decision of *Westmoreland*.⁴⁰ In that case, the Court of Appeal held that the Commissioner's claims for PAYE deductions ranked behind those of a floating debenture holder. In essence, the purpose of the amendment was to ensure the priority of unpaid PAYE over floating charges. It was not, however, intended to change the ranking of PAYE so that it ranked ahead of other preferential claims (such as employees owed wages and salaries) in s 308(1) of the Companies Act 1955, as was made clear by the Hon Robert Muldoon when introducing the amendment. He said:⁴¹

[The section] deals with the preference given to unpaid tax deductions on the bankruptcy or liquidation of an employer. It was always intended when PAYE was introduced that unpaid tax deductions in these circumstances were to rank in preference immediately after certain debts referred to in section 308 of the Companies Act.

⁴⁰ *Re Westmoreland Box Co*, above n 13.

⁴¹ (19 November 1968) 358 NZPD 3205.

[40] Section 365(1) and (2) of the Income Tax Act 1976 replicated s 31(1) and (2) of the Income Tax Assessment Act, and in turn became what is now s 167(1) and (2) of the Tax Administration Act.⁴²

[41] In summary, prior to the 1957 introduction of PAYE, the Crown had the first priority to amounts required to be deducted by way of trust or an ultimate charge. However, from 1957 onwards, the legislative provisions made the trust susceptible to cessation in certain circumstances upon liquidation. These circumstances were outlined in s 31(2) of the Income Tax Assessment Act 1957, s 365(2) of the Income Tax Act 1976 and are currently located in s 167(2) of the Tax Administration Act 1994. This meant that unpaid and overdue PAYE was, upon liquidation, to rank after the claims of certain other preferential creditors.

Conclusion

[42] Drawing together these threads, s 167(2) applies on liquidation or receivership when one of two conditions is met: first, where the employer has failed to deal with the amount withheld or deducted in the manner required by s 167(1); and secondly, where the employer has failed to deal with the amount in accordance with the PAYE rules.⁴³

[43] This means that, in the event of liquidation, s 167(2) and the priorities set out in that subsection apply to all amounts of PAYE withheld which fell due before liquidation but were not paid before liquidation to the Commissioner. Section 167(1) does not apply to such amounts, unless (possibly) unpaid PAYE deducted has been segregated by the employer in a separate account. Amounts of PAYE that fall due for payment after liquidation will, however, remain subject to s 167(1).

[44] Where one of the conditions in s 167(2) is met, the amount of PAYE deducted falls to be dealt with in accordance with sch 7 of the Companies Act. As a result, other preferential claims, including for wages or salary, rank above the Commissioner's claim for unpaid and overdue PAYE.

⁴² The preferential creditors regime in the Companies Act 1955 has been altered and relocated in the Companies Act 1993. Section 167 refers to the current preferential creditors regime, which is located in s 312 and sch 7 of the 1993 Act.

⁴³ And perhaps also when both conditions are met.

[45] The statutory wording of s 167, the caselaw, the legislative scheme and the legislative history all support the above interpretation.

Application to this case

[46] All the PAYE at issue in this case had been deducted but not paid to the Commissioner on its due date and it remained unpaid at the time of liquidation. The funds were not kept by Jennings in a separate account. This means that all of the PAYE that was unpaid at the time of liquidation in this case (including the credit balance in the bank account of \$14,076.38) is dealt with under s 167(2) and is thus distributed in accordance with the priorities set out in sch 7 of the Companies Act. This conclusion is consistent with that reached by Ellen France J⁴⁴ and by Associate Judge Doogue⁴⁵ in this case.

Nature of the s 167(1) trust

The parties' submissions

[47] For Jennings, it is submitted that s 167(1) only applies to funds set aside in a separate account at the time of deduction. If that is not accepted, it is submitted for Jennings, relying on *James Roscoe (Bolton), Ltd v Winder*,⁴⁶ that the s 167(1) trust only attaches to the lowest balance in the bank account between the time of deduction and liquidation and that, in any event, this trust comes to an end on the due date for payment of the PAYE.⁴⁷ To the extent that amounts are not subject to a trust under s 167(1), the amounts are subject to a charge under s 169.

[48] For the Commissioner, it is contended that s 167(1) creates a statutory notional trust in the nature of a floating charge. It is not a traditional trust. The trust applies not just to sums actually deducted but also to those deemed to be deducted and it is recognised that, in general, sums will not be set aside for PAYE purposes. This trust remains operative at the time of liquidation over any positive amount held in a company's bank accounts.

⁴⁴ *Jennings* (CA), above n 3, at [61]–[65].

⁴⁵ *Jennings* (HC), above n 2, at [14]–[19].

⁴⁶ *James Roscoe (Bolton), Ltd v Winder* [1915] 1 Ch 62 (Ch).

⁴⁷ The appellants' written submissions appeared, however, to accept that s 167(1) only ceased to apply upon liquidation.

[49] The Commissioner submits that Jennings' interpretation would deprive the words of s 167(1) of any meaningful effect. The Commissioner also submits that the interpretation of s 167(1) favoured by the Commissioner protects the employee to the maximum extent possible from being pursued for the unpaid PAYE under s RA8 of the Income Tax Act 2007 and s 168(2) of the Tax Administration Act.

Discussion

[50] As a matter of construction of the relationship between s 167(1) and (2), we have already rejected the Commissioner's interpretation of s 167(1) as continuing to apply to any credit balance held in a company's accounts at liquidation. This means that it is not strictly necessary for us to come to a definitive view on the nature of the s 167(1) trust but, as it was fully argued before us, we make five general observations.

[51] First, Jennings' submission that s 167(1) only applies to funds set aside in a separate account is consistent with the interpretation of similar provisions in Canada. In *Royal Bank of Canada v Sparrow Electric Corp*⁴⁸ the subsection in question, s 227(4) of the Income Tax Act 1985 (Can),⁴⁹ was essentially in the same terms as the first part of s 167(1) up to the words "shall be held in trust for the Crown". The Court in *Sparrow* held that, as soon as the deductions become intermingled with the general assets, then "Her Majesty's claim ... then be[comes] that of a beneficiary under a non-existent trust".⁵⁰

[52] The "trust" was upheld in *Sparrow* only because of the next subsection, s 227(5), which provided that the trust extended to "an amount equal to any amount" deemed to be held in trust under s 227(4). The effect of s 227(5) was to attach a beneficial interest for the Crown to property of the debtor in existence at liquidation. Thus s 227(5) had the effect of "revitalising the trust whose subject matter has lost

⁴⁸ *Royal Bank of Canada v Sparrow Electric Corp* [1997] SCR 411.

⁴⁹ Income Tax Act RSC 1985 c 1 (5th Supp).

⁵⁰ *Royal Bank of Canada v Sparrow Electric Corp*, above n 48, at [28] per Gonthier J on behalf of La Forest and Cory JJ (dissenting, but giving the lead judgment on this point). The majority judgment only disagreed with the minority judgment's approach with regard to a point which is not relevant to this appeal: see at [90] per Iacobucci J writing on behalf of Sopinka, McLachlin and Major JJ.

all identity”.⁵¹ There is no such extension to amounts equal to the deduction or amounts withheld in our provision, s 167(1).

[53] There was a similar finding about intermingling destroying any trust in *British Columbia v Henfrey Samson Belair Ltd.*⁵² The provision in *Henfrey*, like our s 167(1), provided that any tax collected shall be deemed to be held separate from and form no part of the collector’s money, assets or estate. The Court said that this did not help the Crown as there was no property that could “be regarded as being impressed with a trust” because of the intermingling with other assets and the fact it could not be traced.⁵³

[54] If we follow the Canadian cases, any trust set up by s 167(1) would only operate where:

- (a) property is set aside in a separate account for PAYE purposes; or
- (b) to the extent of the lowest balance of a mixed fund after the withholding takes place, assuming the reasoning in *James Roscoe* applies.⁵⁴

[55] We do, however, consider it unlikely that the purpose of s 167(1) was so narrow, particularly as it has never been general practice to segregate the PAYE deductions in New Zealand.⁵⁵ There is therefore much to be said for the Commissioner’s submission that the trust created in s 167(1) is intended to be a notional statutory trust.⁵⁶ If it was intended to be a true trust, then there would have been no need (apart from for the avoidance of doubt) for the added wording about it forming no part of the estate in bankruptcy or liquidation. This is because property held in a true trust is not available for creditors (except in limited circumstances).

⁵¹ At [31] per Gonthier J. This point was reiterated by the Canadian Supreme Court in *First Vancouver Finance v Minister of National Revenue* 2002 SCC 49, [2002] 2 SCR 720 at [4].

⁵² *British Columbia v Henfrey Samson Belair Ltd* [1989] 2 SCR 24.

⁵³ At 34. The next part of the British Columbian provision differed from s 167(1) but the comments of the Canadian Supreme Court are still relevant.

⁵⁴ *James Roscoe (Bolton), Ltd v Winder*, above n 46.

⁵⁵ See above at [22].

⁵⁶ We do not, however, consider it helpful to characterise the s 167(1) trust as being in the nature of a floating charge.

[56] The classification of the trust under s 167(1) as a notional trust may be supported by the fact that under s 4A(2)(b) of the Tax Administration Act, the tax is deemed to be withheld if an employee is paid his or her net salary or wages. As a result, an employer can be held to be holding PAYE on trust, even if the employer withholds no money or, in fact, has an overdraft. The withholding deeming provisions lend support to the view that s 167(1) envisages a notional trust over the employer's assets generally.

[57] Secondly, in the context of what can be deemed or notional deductions of PAYE, we would not limit the notional statutory trust under s 167(1) to funds in bank accounts. If it is not so limited before liquidation, then it is difficult to see why it would be so limited at the time of liquidation, as the Commissioner contends it is. This is an added reason for rejecting the Commissioner's interpretation of the relationship between s 167(1) and (2).

[58] Thirdly, we do not accept that the Commissioner's interpretation in part protects employees from being pursued for unpaid PAYE in the event of the liquidation of the employer. An employee is not liable for PAYE on liquidation unless that employee has received the gross amount of his or her salary or wages⁵⁷ or has received from the employer a benefit in cash or kind equal to the PAYE that should have been deducted.⁵⁸

[59] If an employee has not received the PAYE either in cash or kind, then, contrary to the Commissioner's submission,⁵⁹ that employee is not liable for that PAYE. It would be most unfair if the situation were otherwise and the employee took the risk of insolvency or non payment of PAYE that had been deducted, either

⁵⁷ See ss RD 5 and RD 21 of the Income Tax Act 2007 and s 4A(2)(b) of the Tax Administration Act.

⁵⁸ Income Tax Act, s RA 8. Contrary to the Commissioner's submission, the term "benefit" in this section does not apply to a tax credit given for PAYE that has been withheld from salary and wages. The tax credit is a function of the PAYE regime and not a benefit provided by or on behalf of the employer.

⁵⁹ The Law Commission made a similar error in its report: *Priority Debts in the Distribution of Insolvent Estates: An Advisory Report to the Ministry of Commerce* (NZLC SP2, 1999) at [114]. This is because s 4A(2)(b) of the Tax Administration Act deems that PAYE has been withheld when an employee is paid their net wages or salary. As a result, under s RD 21, if the employee has received their net salary or wages, they will not be liable for outstanding PAYE under that section.

actually or notionally, as that employee has no control over the funds or the actions of the employer.⁶⁰

[60] Fourthly, we would not accept Jennings' submission that the s 167(1) trust comes to an end when there is a failure to pay PAYE on the due date. We are inclined to agree with the Court of Appeal position in *Smith* that a wrongful act of the trustee (the employer) should not bring the trust to an end.⁶¹ On liquidation, as *Smith* found, any trust is, however, brought to an end not by any action of the company but by virtue of the legislation under s 167(2).⁶²

[61] Finally, a notional trust of this kind, as was accepted by the Court of Appeal in *Smith*, would protect from clawback amounts actually paid (whether late or not) to the Commissioner before liquidation.⁶³ This gives a major protection to the Commissioner and can be regarded as providing a proper purpose for s 167(1) which the Canadian "empty trust" interpretation would not. We do not wish to be definitive on whether *Smith* was rightly decided on this point, however, as this case is not concerned with amounts paid before liquidation.

Result

[62] Upon the liquidation of Jennings, the unpaid (and overdue) PAYE fell subject to sch 7 of the Companies Act by virtue of s 167(2)(b) of the Tax Administration Act. As a result, the unpaid PAYE ranks in accordance with sch 7 of the Companies Act.

[63] The appeal is allowed. The respondent must repay the \$14,076.38 at issue in the appeal to the appellants.

[64] The respondents are to pay to the appellants costs of \$25,000 plus reasonable disbursements (to be set by the Registrar if necessary).

⁶⁰ That this is the position is reinforced by s LB 1 of the Income Tax Act, which provides that a tax credit is given even if the amount has not been paid.

⁶¹ *Commissioner of Inland Revenue v Smith*, above n 13, at [13].

⁶² As a result, we reject the Commissioner's contention that the trust comes to an end by virtue of the actions of the liquidator acting as an agent on behalf of the company. We make no comment on whether the role of a liquidator is as an agent of a company.

⁶³ See *Commissioner of Inland Revenue v Smith*, above n 13, at [14].

[65] Leave is reserved to apply (on or before 12 December 2014) for any consequential orders relating to the repayment of the funds, interest and costs in the High Court and Court of Appeal.

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