HOUSING INDUSTRY ASSOCIATION

Housing Australians

Submission to the
Senate Economics Legilsation Committee

Treasury Laws Amendment (Combatting Illegal Phoenixing) Bill 2019

14 March 2019

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ABOUT THE HOUSING INDUSTRY ASSOCIATION

The Housing Industry Association (HIA) is Australia's only national industry association representing the interests of the residential building industry, including new home builders, renovators, trade contractors, land developers, related building professionals, and suppliers and manufacturers of building products.

As the voice of the industry, HIA represents a membership of 60,000 throughout Australia. The residential building industry includes land development, detached home construction, home renovations, low/medium-density housing, high-rise apartment buildings and building product manufacturing.

HIA members comprise a diversity of residential builders, including the Housing 100 volume builders, small to medium builders and renovators, residential developers, trade contractors, major building product manufacturers and suppliers and consultants to the industry. HIA members construct over 85 per cent of the nation's new building stock.

HIA exists to service the businesses it represents, lobby for the best possible business environment for the building industry and to encourage a responsible and quality driven, affordable residential building development industry. HIA's mission is to:

"promote policies and provide services which enhance our members' business practices, products and profitability, consistent with the highest standards of professional and commercial conduct."

The residential building industry is one of Australia's most dynamic, innovative and efficient service industries and is a key driver of the Australian economy. The residential building industry has a wide reach into manufacturing, supply, and retail sectors.

The aggregate residential industry contribution to the Australian economy is over $150 billion per annum, with over one million employees in building and construction, tens of thousands of small businesses, and over 200,000 sub-contractors reliant on the industry for their livelihood.

HIA develops and advocates policy on behalf of members to further advance new home building and renovating, enabling members to provide affordable and appropriate housing to the growing Australian population. New policy is generated through a grassroots process that starts with local and regional committees before progressing to the National Policy Congress by which time it has passed through almost 1,000 sets of hands.

Policy development is supported by an ongoing process of collecting and analysing data, forecasting, and providing industry data and insights for members, the general public and on a contract basis.

The association operates offices in 23 centres around the nation providing a wide range of advocacy, business support including services and products to members, technical and compliance advice, training services, contracts and stationary, industry awards for excellence, and member only discounts on goods and services.

1. INTRODUCTION

On 14 February 2019 the *Treasury Laws Amendment (Combatting Illegal Phoenixing) Bill 2019* (**Bill**) was referred to the Senate Economics Legislation Committee for inquiry. HIA provides these submissions in response to the Bill.

In 2017, HIA responded to the discussion paper *Combatting Illegal Phoenixing* (**2017 Discussion Paper**). It is acknowledged that the measures contained in the Bill are based on proposals included in the 2017 Discussion Paper, a number of which HIA supported. Similarly HIA supports a number of reforms within the Bill that seek to respond to illegal phoenixing behaviour.

HIA does not support individuals who engage in illegal phoenixing. Individuals who hide behind the shield of a company to incur debts such as payments due to employees and subcontractors without any intention of paying those debts, abuse the corporate form. Those individuals obtain an unfair competitive advantage over the majority of businesses that comply with their obligations and are acting outside their legal obligations and community expectations. Strong punishment and sanctions should apply to such individuals.

HIA does, however remain concerned that some aspects of the Bill amount to "overcapture" and go well beyond the remit granted under the banner of targeting illegal phoenixing activity.

The incorporated entity remains the chosen (and best) legal structure for hundreds of thousands of businesses. Any additional laws should not dilute the economy-wide benefits of incorporation nor simply be another means to address revenue shortfalls.

Further measures to address phoenix activities should primarily target those directors and persons who engage in the practice. Ordinary businesses, many of whom are "mums and dads", never intend to phoenix and should not be penalised merely because at some point their business might fail.

For example, the extension of the director penalty regime for unpaid goods and services taxes (GST) is a measure targeted to all companies, not just those engaged in wrongdoing. It will unnecessarily add to the day-to-day risks of running a small company. Both the Commissioner of Taxation and the ATO currently have broad and extensive asset and debt recovery powers. New laws should not be a substitute for better resourcing and the better use of existing laws.

In HIA's submission, a more appropriate measure would be the introduction of a statutory definition of phoenix behaviour. This would provide directors with clarity and improved certainty in relation to what conduct is captured. Unfortunately the measures in the Bill characterised as a 'phoenixing offence' essentially reflect a liquidators existing ability to claw back transactions considered to be 'voidable'. Whilst the new offences associated with conduct captured by a 'creditor-defeating disposition' are welcomed this approach does little to respond to the harmful impact associated with illegal phoenixing activity on Australia's revenue base and the competitive 'level playing field'.

2. GENERAL COMMENTS

2.1 THE BENEFITS OF THE CORPORATE FORM

It is a fundamental principle of company law in Australia (and elsewhere) that a company is a separate legal person, independent of its directors and shareholders. A company is responsible for its own debts and liabilities.

These basic principles are one of the reasons why the corporate form is favoured for the conduct of commercial enterprise. It enables much of the entrepreneurship, investment and innovation that facilitates economic growth.

Incorporation means an investor can share in the profits of an enterprise without being involved in its management. It provides structures for joint ventures; continuing trusteeship; fund management; and, the co-enjoyment of property.

Importantly, incorporation enables a business to carry on with a perpetual existence. It is not dependent on the life of the owner/manager. Even if the shareholders, directors, and officers come and go, the corporation carries

on. This permanency means that management can make long-term decisions for the business. Investors also have a better chance to see a return on their money. The majority of companies are established with a view to this permanency.

In the residential building industry, the corporate structure is adopted by many businesses as this is the best way to enable management of the various business functions from general and financial administration to sales, marketing, ordering, design and occupational health and safety.

Despite incorporation being a popular business structure, many small residential builders and contractors still continue to operate as sole traders and do not want to spend the time or the money it would take to create a separate business entity. Incorporation carries increased paperwork and accounting costs that are considered too burdensome.

The measures contained in the Bill need to take into account the existing regulatory burden and obligations of company directors and officers.

2.2 Phoenixing and the Residential Construction Sector

According to ASIC the “construction” industry appears largely represented in the overall number of insolvencies across the economy.

It should however be recognised that the construction industry is not homogenous.

The industry is divided amongst those businesses operating in detached residential, multi-residential, renovation, commercial, public infrastructure and civil works sectors. There are also a range of different categories of business and practitioner - from property developers and joint venture capital investors to commercial head contractors, builders, subcontractors and consultants.

Adopting a corporate structure is regarded as an appropriate risk management strategy to respond to project and business risks.

During a project, the first risk that threatens solvency is financial. Cost overruns can result from a number of reasons including poor estimating, under-budgeting, overly optimistic pricing or cut price tendering, poor coordination between design professionals and the trades, delayed project stage payments, and changing client demands.

The second risk relates to time. Time overruns (and delayed payments) can have devastating financial consequences for businesses in the construction industry.

The final risk relates to the design of the building. There is a risk that the completed building will not meet the owner’s needs.

After the construction phase, ongoing responsibility for defects and warranties is a key risk.

Some businesses manage these risks by using asset-poor, project specific companies.

HIA does not seek to discount phoenix behaviour when it occurs, however it is important to recognise that these project specific vehicles are not commonly used in the detached housing sector compared to other sectors of the construction industry.

HIA rarely comes across residential builders who deliberately sabotage the solvency of their business.

In HIA’s experience, some companies in the sector fail because of poor business administration while others collapses due to the actions of third parties, most notably non-payment.

There are unique elements of the regulatory framework that apply to residential (domestic) building work nationally, including mandatory licensing and homeowners warranty insurance system, that reduce the ability for directors of residential building companies to utilise phoenix arrangements.

Firstly, in all states and territories builders need a builder's licence or registration to contract, sub-contract or advertise, to undertake residential building work.

As part of the licensing eligibility process, applicants are subject to strict financial and personal probity requirements. There are existing exclusions for bankrupts. Directors who have controlled an insolvent company may be automatically excluded or otherwise will fail the "fit and proper" person requirements.

In Western Australia, for instance, under the *Building Services (Registration) Act 2011*, a building company is strictly prohibited from trading without a nominated supervisor and risks significant fines for non-compliance.

Under Section 18, the WA Building Commission has the power to require an applicant or renewing practitioner to satisfy the Board about sufficient material and financial resources. The Commission also has inquisitorial powers to investigate a builder's activities, including financial competence.

There are also ineligible person provisions within this section that prohibit certain persons involved in previous company and business failures from taking part in the management and supervision of building work. Similar laws exist in all States and Territories.

The Queensland government recently passed legislation to address phoenixing including broad exclusions of 'shadow directors' and 'influential persons'.

Those who have been involved with failed 'construction companies' outside of Queensland are also expressly excluded from obtaining a licence.

Another defining feature of the residential building industry is the mandatory regime of builder's indemnity or Home Warranty Insurance (HWI). HWI operates in every jurisdiction except for Tasmania.

Since 2001, HWI schemes have been one of "last resort". This means that a consumer can access the benefit of the policy of insurance when the builder dies, disappears or is insolvent.

In New South Wales, there is also a fourth trigger that enables a consumer to claim on the policy of warranty insurance when a builder fails to comply with a monetary order issued by the Court or Tribunal.

The operation of mandatory HWI under which the insurer provides a completion guarantee to a home owner in the event of a residential builders' insolvency means that a builder's financial position is consistently monitored by their insurer.

Before granting eligibility, an insurer reviews a builder's business history and finances to assess their risk. Insurers then impose an annual turnover limit on builders based on their assessment of the value of works that a builder can prudently undertake given their financial position.

In some circumstances, insurers require a financial security or deed of guarantee or indemnity of some form before granting eligibility.

These types of measures do not apply in other sectors of the construction industry and they should be recognised when considering the operation of the Bill should it proceed.

3. RESPONSE TO THE BILL

3.1 PHOENIXING OFFENCE

The Bill introduces a new offence labelled a 'creditor-defeating disposition'.

A 'creditor-defeating disposition' captures the transfer of company assets that prevents, hinders or significantly delays creditors access to the company's assets on liquidation. Such transactions may be a voidable transaction recoverable by the liquidator on application to ASIC or the Court.

Those involved, including those that facilitate 'creditor-defeating disposition' transactions, may be subject to criminal charges, civil penalties and compensation orders.

HIA supports the proposed provision and supports moves that extend culpability to advisors and those facilitating illegal behaviour.

However, HIA is concerned that the approach largely mirrors, and potentially overlaps with, existing provisions that deem transactions as voidable under circumstances in which the transaction occurred while the business was insolvent or when directors knew, or should have reasonably known, that the business was insolvent. It is equally arguable that a 'creditor-defeating disposition' falls within one of the existing categories of voidable transactions i.e. unfair preferences and/or uncommercial transactions.

While the introduction of criminal charges and civil penalties accompany such activities is welcomed the approach is not novel or one that strikes at the heart of problem.

HIA maintains that an express definition of illegal phoenixing activity is needed.

HIA understands that providing a definition has been a longstanding topic of debate, given the difficulties in arriving at a definition that does not capture legitimate businesses or alternatively enables exploitation of loopholes by potential phoenix operators. Nonetheless, HIA considers the time has come to provide greater certainty and a legal distinction between legitimate business restructures and potential illegal phoenixing activities.

The University of Melbourne's Helen Anderson has stated that legal phoenix activity covers situations where the previous controllers start another similar business, using a new company when their earlier company fails, usually in order to rescue its business. Illegal phoenix activity involves similar activities, but the intention is to exploit the corporate form to the detriment of unsecured creditors, including employees and tax authorities. The illegality here is generally because of a breach of directors' duties in failing to act properly in respect of the failed company and its creditors.

There is also the more sophisticated case of companies that adopt phoenix activity as a business model from the outset.

An offence of illegal phoenixing must be directed to the deliberate and systematic liquidation of a corporate trading entity which occurs with the fraudulent or illegal intention to:

- avoid tax and other liabilities, such as employee entitlements; and
- continue the operation and profit taking of the business through another trading entity.

The offence should include a defence that a company and/or a director will not be guilty of illegal phoenixing were the behaviour was directed at the honest resurrection of a company.

3.2 Director Resignation

HIA supports Schedule 2 of the Bill.

3.3 Extending the Director Penalty Regime to Unpaid GST

HIA opposes Schedule 3 of the Bill which proposes amending the Director Penalty Regime to add liability for unpaid goods and services tax (GST) making individuals personally liable for unpaid GST.

As a strict liability offence the provisions go well beyond the remit of capturing illegal phoenix activity. The measure will apply indiscriminately and will penalise individuals with no intent to avoid the payment of GST by engaging in illegal phoenixing activity.

The Director Penalty Regime was introduced in 1993 to give the ATO power to make company directors personally liable for unpaid company taxation debts. It was originally limited to unpaid withholding tax for wages.

Section 269-15 of Schedule 1 to the *Taxation Administration Act 1953* provides that the directors of the company (from time to time) on or after the initial day (the day when the company 'withholds an amount') must cause the company to comply with its obligation.

The director's obligation to cause the company to meet its obligation to pay a PAYG withholding or SGC liability commences from the time an amount is withheld or the end of the SGC quarter respectively.

This obligation continues until:

- the company complies with its obligation; or
- an administrator of the company is appointed under section 436A, 436B or 436C of the Corporations Act; or
- the company begins to be wound up.

According to the Explanatory Memorandum to the *Tax Laws Amendment (Transfer of Provisions) Bill 2010*:

> *"the penalty regime reflects the public duty on directors to ensure that amounts withheld from payments to third parties are promptly forwarded to the Commissioner. The public duty arises because withheld amounts are similar in nature to amounts held on trust. That is, the directors are in a position of trust and have a duty to protect those monies until they have been forwarded to the Commissioner."*

These rules can have a harsh application as the time allowed within which to arrive at an agreement with the Commissioner, appoint an administrator, or commence the winding up of the company is very short.

Unlike PAYG and superannuation, GST is an indirect broad based tax.

After 19 years, the basic operation of the tax may now be well known, but it is still quite a complex tax as it applies to certain transaction.

Under the GST laws, all prices and monetary consideration are treated as GST inclusive. The "supplier" is liable for GST on taxable supplies that it makes, however the supplier does not have a legislative right to charge an additional amount for GST to the recipient of its taxable supply. It becomes a contractual issue to ensure that a supplier can recover an additional amount in a position of trust and have a duty to protect those monies until they have been forwarded to the Commissioner.

Land sales, in particular real property transactions, have consistently given rise to complex and intricate GST issues for taxpayers.

Further for small businesses, the implications of accounting GST on either a cash or non-cash (accrual) basis may greatly affect the cash flow of their business, as GST is payable on sales for which payment has not yet been received. This can leave businesses substantially out of pocket, even if GST can also be claimed on unpaid expenses if you hold a tax invoice.

This type of proposal represents a fundamental overhaul to the personal liability of all directors, not just those involved in phoenix activity.

GST compliance is one of the largest sources of red tape burden for HIA's members.

HIA notes that MYOB has estimated that the time lost to GST compliance for the approximate 2 million small businesses in Australia equates to a productivity cost of $13.5 billion.

Adding the threat of personal lability for unpaid GST will further add to this burden.

3.4 Retaining of Refunds

Schedule 5 of the Bill proposes to give the Commissioner the power to retain tax refunds where a taxpayer has failed to lodge a return or provide other information that may affect the amount the Commissioner refunds.

HIA supports measures that seek to address conduct that allows businesses to take advantage of administrative processes that enable the receipt of refunds quickly, but delay or avoid the lodgement of returns expected to result in liability and then engage in illegal phoenixing behaviour leaving amounts outstanding.

HIA is concerned that the strict liability approach prioritises the desire to redress revenue shortfalls. In those circumstances a regulatory response is inappropriate and non-regulatory options should be considered and are preferred.

Equally concerning is that this strict liability approach will inevitably capture those with no intention to avoid their obligations. There may be a number of reasons why a business, particularly a small business, may not have lodged an income tax return in a timely way.

To prevent any unintended consequences HIA submits that further consideration be given to the approach outlined in the 2017 Discussion Paper that suggested measures of this type would be targeted at entities designated as *High Risk Entities* (**HRE**). While HIA did have some concerns with that approach, it is preferred that these measure be legislatively confined to those entities at a high risk of engaging in illegal phoenixing activity.

The use of an approach that includes the categorisation of entities as HRE also provides a signal to businesses of behaviour considered unacceptable, assists the ATO in focusing their efforts to target and prevent illegal phoenixing activity and opens a dialogue with those HRE to prevent them in engaging in such activities.

While HIA notes that the Explanatory Memorandum indicates that guidance will be issued on the use of the discretion, HIA's preference would be that the power and its application be set out in the legislation, adding clarity and certainty. For example, HIA submit that a show cause process be include so that **before** a refund is withheld in circumstances where a return has not been lodged the entity be notified that such action may be taken. A dialogue can then be entered into with the business to understand why they may have failed to lodge a return in a timely way.