The Parliament of the Commonwealth of Australia

Advisory report on the Tax Laws Amendment (2011 Measures No. 8) Bill and the Pay As You Go Withholding Non-compliance Tax Bill 2011

House of Representatives
Standing Committee on Economics

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Chair’s foreword

The Tax Laws Amendment (2011 Measures No. 8) Bill 2011 and the Pay As You Go Withholding Non-Compliance Tax Bill 2011 propose four sets of changes to the tax laws. Two of these changes generated stakeholder interest and were pursued by the committee in the inquiry.

The first item of interest was changes to the Petroleum Resource Rent Tax (PRRT), which has been the subject of dispute between ExxonMobil and the Australian Taxation Office (ATO). The dispute revolves around the definition of a marketable petroleum commodity, which affects where the taxing point occurs. The later the taxing point, the more valuable the commodity being taxed. Since the PRRT is a tax on profits, a later taxing point involves more tax.

The issue about these amendments was that they apply back to 1990-91, which raises the question about whether this retrospectivity is warranted. Parliaments do legislate retrospectively from time to time. The important point is that retrospective legislation should be fair and provide certainty. In this case, the committee is confident that this applies. The Bills are implementing the original policy intent that applied 20 years ago and also reflect how the PRRT has operated since that time, including how ExxonMobil has been lodging its tax returns and paying tax. Further, Treasury provided the committee with a timeline of the dispute that demonstrates that successive Governments have consistently interpreted the legislation in this way.

The second aspect to the Bills was the changes to tax penalties for company directors for the superannuation guarantee charge, which have been motivated by phoenix operators. These companies build up debt, become insolvent, liquidate their debts, and then continue the business through a new company that will eventually go through the same process. The problem addressed in this Bill is that the companies are insolvent partly because they are carrying debts for their staff

entitlements, including superannuation. Millions of dollars of employees' superannuation is lost every year through this practice.

The ATO is on the record as stating that it has insufficient legal powers to enforce the superannuation guarantee charge. Recovering the amounts is also difficult in practice because of the long time delay in the ATO becoming aware of the non-payment. Phoenix operators enjoy an unfair competitive advantage against their competitors who do the right thing. The crude nature of this business model is reminiscent of the bottom of the harbour schemes in the early 1980s.

Broadly, the Bills make company directors liable for their companies superannuation guarantee debt. The Bills also remove the requirement for the ATO to issue a 21 day director penalty notice before commencing legal action on a company director. The 21 day period is problematic because phoenix operators promptly cause their company to go into voluntary administration shortly after receiving their notice, which prevents the ATO taking further action against them.

In general, the committee supports these provisions because they are taking penalties that already successfully apply to the PAYG system and extending them to superannuation. Employers' obligations in relation to super remain the same; what will change is that these obligations will now be more rigorously enforced.

However, at the hearing business groups expressed concerns about the provisions because they wanted to ensure that honest company directors would not be caught up in them by accident. The committee accepts that directors who act in good faith should have some comfort that they will not be subject to the provisions. The committee recommended that the Government investigate whether the Bills should specifically target phoenix operators and whether the defences in the Bill should be expanded.

Because of the work involved in this, the committee has recommended that Schedule 3 of the Tax Laws Amendment (2011 Measures No. 8) Bill 2011, which contains the phoenixing provisions, should be deleted so that the remainder of the Bill may pass. The Pay As You Go Withholding Non-Compliance Tax Bill 2011 should remain pending while the Government completes its investigations.

I would like to thank the organisations that assisted the committee during the inquiry through submissions or participating in the hearing in Canberra. I also thank my colleagues on the committee for their contribution to the report.

Julie Owens MP
Chair

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Membership of the Committee

Chair	Ms Julie Owens MP
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Terms of reference

On 13 October 2011, the Selection Committee asked the Committee to inquire into and report on the Tax Laws Amendment (2011 Measures No. 8) Bill 2011, and the Pay As You Go Withholding Non-Compliance Tax Bill 2011.

Under Standing Order 222(e), the House is taken to have adopted the Selection Committee's reports when they are presented.

AICD	Australian Institute of Company Directors
APPEA	Australian Petroleum Production and Exploration Association
ATO	Australian Taxation Office
COSBOA	Council of Small Business of Australia
ICAA	Institute of Chartered Accountants in Australia
IGT	Inspector-General of Taxation
PAYG(W)	Pay As You Go (Withholding)
PRRT	Petroleum Resource Rent Tax
SG	Superannuation Guarantee

Recommendation 1

The Government investigate whether it is possible to amend the Bills to better target phoenix activity.

Recommendation 2

The Government explore whether to expand and strengthen the defences for company directors available in the Bills.

Recommendation 3

The House of Representatives pass the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 after deleting its Schedule 3 and associated provisions. The Pay As You Go Non-compliance Tax Bill 2011 should remain pending the Government's investigations detailed in recommendations 1 and 2.

1

Introduction

Background

1.1 On 13 October 2011 the Selection Committee referred the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 and the Pay As You Go Withholding Non-compliance Tax Bill 2011 to the committee for inquiry and report.

1.2 The Bills were introduced by the Government into the House of Representatives earlier on the same day.

Purpose and overview of the Bills

1.3 There are four parts to the Bills:

- to provide the Commissioner of Taxation with discretion to disregard certain events that would otherwise trigger the assessment of certain income for a primary production trust;
- to clarify that the taxing point for the Petroleum Resource Rent Tax (PRRT) is when a product reaches its final form, rather than when it first chemically meets the definition of a marketable petroleum commodity;
- to extend the director penalty regime to make directors personally liable for their company's unpaid superannuation guarantee amounts; and

- to make minor consequential amendments to the taxation arrangements for gaseous fuels.

1.4 The second and third parts generated the most interest from stakeholders and the committee pursued these aspects in the inquiry.

Petroleum Resource Rent Tax

1.5 Schedule 2 of the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 amends the *Petroleum Resource Rent Tax Act 1953* (TAA 1953). It has two main effects, the first of which is to amend the definition of a marketable petroleum commodity as follows:

> (1) A marketable petroleum commodity is a product listed in subsection (2) that:
>
> (a) is produced from petroleum for the purpose of:
>
> (i) sale; or
>
> (ii) use as a feedstock for conversion to another product (whether a product listed in subsection (2) or not); or
>
> (iii) direct consumption as energy; and
>
> (b) is in its final form for that purpose.
>
> (2) The products are as follows:
>
> (a) stabilised crude oil;
>
> (b) sales gas;
>
> (c) condensate;
>
> (d) liquefied petroleum gas;
>
> (e) ethane;
>
> (f) any other product specified in regulations made for the purposes of this paragraph.
>
> (3) However, a product cannot be a marketable petroleum commodity if it has been produced wholly or partly from a product that was a marketable petroleum commodity.

1.6 The Schedule's second main effect is to apply the definition back to the tax year commencing 1 July 1990.

1.7 Subsections (2) and (3) in the new definition are very similar to the current provisions. The new aspect to the definition is subsection (1), in particular the clause 'is in its final form for that purpose'. Petroleum companies can have a chain of production processes, commencing with drilling and extraction, but then also processing, where a product can be separated and filtered in order to meet the specifications for the market in which the company wishes to compete.

1.8 For example, a product might meet the chemical definition of being liquefied petroleum gas before being processed and might have a possible commercial demand. Subsection (1) makes it clear that a product becomes a marketable petroleum commodity when it reaches the state at which the company's operations are designed for it to be sold, used for energy by the company, or to be converted to another product. In other words, the definition depends on the commercial context of the project in question.

1.9 This definition is important because the term 'marketable petroleum commodity' is used in section 24 of the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTA Act), along with other terms such as an 'excluded commodity', to determine a company's assessable petroleum receipts. The PRRT is calculated as 40 per cent of a company's petroleum profits, which depend on its assessable petroleum receipts. If the point at which assessable petroleum receipts are calculated is earlier in the production process when the product is less valuable, this will reduce receipts and profits for tax purposes, and thus reducing the tax liability.

1.10 The current definition of a marketable petroleum commodity was considered by the Federal Court in *Esso Australia Resources Pty Ltd v The Commissioner for Taxation [2011] FCA 360*. The judgement was delivered in April this year. Esso (ExxonMobil) argued that the 'taxing point' occurs at the earliest stage when the product meets the relevant chemical composition, regardless of whether it would subject it to further processing for sale. The Court agreed with the Commissioner that the current definition implies the later taxing point and that this question must be decided in the context of the project as a whole. After analysing the Act, Justice Middleton stated, 'This points to an actual sale or "marketability" being a concept at the heart of the determination of liability under the PRRTA Act'.[1]

1.11 The Bill is seeking to confirm the Court's decision. The Explanatory Memorandum states that the Court's decision and the approach in the Bill confirm 'the long established application of the PRRT'. It also notes that Esso's interpretation would lead to greater uncertainty because a derived (or estimated) market value would needed to calculate the tax amount since the company is not seeking to sell the product at this point in the production process.[2]

1 Esso Australia Resources Pty Ltd v The Commissioner for Taxation [2011] FCA 360, para 222.

2 The Hon. Wayne Swan MP, *Explanatory Memorandum* to the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 and the Pay As You Go Withholding Non-compliance Tax Bill 2011, 2011, pp. 16-17.

1.12 At the Budget in May this year, the Government announced its intention to clarify the taxing point and entrench the decision in *Esso*. The Bill gives effect to this policy commitment.

Company directors and the superannuation guarantee

1.13 Schedule 3 of the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 amends the *Taxation Administration Act 1953* (TAA 1953). It does this by:

- extending the director penalty regime to make directors personally liable for their company's unpaid superannuation guarantee amounts;
- allowing the Commissioner of Taxation (Commissioner) to commence proceedings to recover director penalties three months after the company's due day where the company debt remains unpaid and unreported after the three months passes, without first issuing a director penalty notice; and
- in some instances making directors and their associates liable to pay as you go (PAYG) withholding non-compliance tax where the company has failed to pay amounts withheld to the Commissioner.

1.14 The tax on directors and their associates to give effect to denying their credits is imposed by the Pay As You Go Withholding Non-compliance Tax Bill 2011.

1.15 Schedule 3 will provide better protection to workers' entitlements to superannuation, further define the statutory obligations of company directors and enhance the deterrence of fraudulent phoenix activity.

1.16 The proposed amendments are designed to provide disincentives for directors to allow their companies to fail to meet their existing obligations, particularly obligations to employees. They do not introduce new obligations on the company but, rather, penalise company directors who fail to ensure that their companies meet their obligations under the existing director penalty scheme.

1.17 This scheme was introduced in 1993 to assist the Australian Taxation Office (ATO) to recover certain company liabilities. The director penalty regime replaced the Commissioner's priority that previously existed under insolvency law for certain amounts withheld (particularly from salary or wages), but not paid to the Commissioner. The director penalty regime was re-written into Division 269 in Schedule 1 to the TAA 1953 in 2010, with minimal policy change.

1.18 The regime ensures that directors cause their company to meet certain tax obligations or promptly put the company into liquidation or voluntary administration. This applies generally to directors of all non-complying companies, not simply phoenix companies.

1.19 The tax laws require companies to withhold amounts from certain payments they make, such as wages to employees and fees to directors. The withheld funds must be paid to the Commissioner or, where applicable, to pay estimates of those funds.

1.20 The director penalty regime has always made directors of non-compliant companies personally liable for the amount that the company should have paid, through imposition of a penalty.

1.21 While the existing director penalty regime makes directors liable to a penalty, at the end of the day the company is left with the responsibility to meet its obligation.

1.22 Furthermore, as the existing regime allows directors 21 days notice of the penalty before the Commissioner is able to commence proceedings to recover the liability, directors inclined to do so are free to extinguish their personal liability by placing the company into voluntary administration or liquidation within that notice period and before the Commissioner can sue to recover their personal liability. This often means that the full amount of PAYG withholding liabilities is never recovered.

1.23 To compound matters still further, company directors are currently able to claim PAYG withholding credits (for amounts withheld from payments to them by the company) in their individual tax returns, even when the company has failed to pay some or all of its PAYG withholding liability to the Commissioner.

1.24 It is also critical to note that while the director penalty regime addresses non-payment of PAYG withholding amounts to the Commissioner, non-payment of employee entitlements such as superannuation cannot be addressed through the regime. Thus, the Commonwealth has effectively established one standard for its debtors, while leaving other lawful creditors with less effective means of redress.[3]

3 Discussion drawn from the *Explanatory Memorandum* for the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 and the Pay As You Go Withholding Non-compliance Tax Bill 2011.

Factual background

Petroleum Resource Rent Tax

1.25 The PRRT is a Commonwealth tax and applies to areas where the Commonwealth has jurisdiction, in particular the offshore areas outside the three nautical mile boundary. Up until the 1980s, all petroleum was taxed through a royalty and excise, or volume, basis.

1.26 This system had its weaknesses. For example, in order to encourage more oil exploration and extraction, the Government imposed lower tax rates for more recently discovered oilfields. Further, the levy did not take into account changing economic conditions. When oil prices were low, a fixed levy could potentially make oil production uneconomic and when oil prices were high, the nation missed the opportunity to participate in these gains.[4]

1.27 The PRRT is a profits-based tax. The Australian Petroleum Production and Exploration Association provided the following summary of how it works:

- it is assessed on a project basis;
- liability to pay PRRT is on a producer/company;
- it is assessed at a rate of 40 per cent;
- a liability is incurred when all allowable expenditures (including compounding) have been deducted from assessable receipts;
- assessable receipts include the amounts received from the sale of all petroleum;
- deductions include capital and operating costs that relate to the petroleum project, and are deductible in the year they are incurred; and
- undeducted expenditures are compounded forward at a variety of set rates depending on the nature of those expenditures.[5]

1.28 The *Petroleum Resource Rent Tax Assessment Act 1987* was effective from 15 January 1988. It applied retrospectively to exploration permits awarded on or after 1 July 1984, which relates back to the Government's formal announcement of the tax. Initially, it applied to all offshore areas except

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4 Mr Craig Emerson, 'The More Oils Change, the More They Stay the Same' *The Australian*, 7 May 2010, p. 14; Mr Richard Webb, 'Crude Oil Excise and Royalties', Department of the Parliamentary Library, Research Note 29, 2000-01.

5 APPEA, *Submission 1*, p. 1.

for Bass Strait and the North West Shelf. Bass Strait became subject to the PRRT on 1 July 1990.[6]

1.29 The tax has several advantages over the previous levy. For example, the Government does not need to adjust tax rates to achieve certain economic outcomes or to take into account economic conditions. The tax amounts follow oil companies' ability to pay. Further, it encourages companies to more fully exploit available reserves because oil that is more costly to extract will attract lower rates of tax. In effect, the Government has accepted more risk through the PRRT, which has reduced risk for oil companies and led to a more secure supply of oil for the Australian market.

1.30 This feature of the tax was related to the decision to include Bass Strait within the PRRT in 1990. At the time, oil prices were very low, making it less attractive for Esso and BHP to maintain production with high fixed costs caused by a fixed levy. When Bass Strait left the volume system between 1990-91 and 1991-92, crude oil excise collections dropped from $1.3 billion to $64 million. PRRT revenues increased from $300 million to $876 million, which reduced tax on the joint venture by over $600 million at that time. However, this came with the possibility that taxes would increase if oil prices rose.[7]

1.31 Further, the PRRT, as a tax on profits, has no direct effect on the petrol price for consumers because it is absorbed by petrol companies. A levy, similar to other volume based taxes, would directly raise prices for consumers.[8]

1.32 The trigger for the Bills has been a long running court case between ExxonMobil and the Tax Office about the taxing point under the PRRT. The case commenced in 2004, following correspondence and discussions between the Bass Strait joint venturers and the Tax Office for the previous 10 years. The case concerns the tax liability for the Bass Strait joint venturers from 1990-91 to 2001-02, which were the relevant periods when the legal action commenced.

1.33 ExxonMobil stated in evidence that, the maximum refund to which they would be entitled in relation to the dispute between the years 1990-91 to

6 Department of Resources, Energy and Tourism, 'The History of Petroleum Resource Rent Tax (PRRT)' <http://www.ret.gov.au/resources/enhancing/taxation/prrt/Pages/TheHistoryofPetroleumResourceRentTax(PRRT).aspx> viewed 17 October 2011.

7 Mr James O'Toole, Treasury, *Committee Hansard*, Canberra, 27 October 2011, p. 6; Mr Stuart Brown, ExxonMobil Australia, *Committee Hansard*, Canberra, 27 October 2011, p. 13.

8 Mr Richard Webb, 'Petroleum Resource Rent Tax (PRRT)' Department of the Parliamentary Library, Research Note 20, 2000-01.

2001-02 would be $323 million.[9] It appears that BHP's liability would be for a comparable amount.

1.34 In April this year, the Tax Office won a decision in the Federal Court with a single judge. Justice Middleton found that the definition of a 'marketable petroleum commodity' depended on the commercial context of a project, rather than when it met the chemical composition of sales gas, liquefied petroleum gas, stabilised crude oil, or any of the other compounds listed in the legislation. This implied a higher value of the product at the taxing point, which was consistent with the tax payments made by ExxonMobil and BHP since 1990-91.

1.35 In the May Budget, the Government announced that it would legislate to confirm the Court's decision. The Budget Papers state:

> The Government will amend the tax law to provide greater certainty around how the taxing point is calculated for the purposes of the Petroleum Resource Rent Tax (PRRT), with effect from 1 July 1990. This measure will confirm existing application of the PRRT in relation to the taxing point and will provide greater certainty for PRRT taxpayers.
>
> The location of the taxing point within a PRRT project is used in determining PRRT liabilities, and was the central issue recently considered by the Federal Court in *Esso Australia Resources Pty Ltd v The Commissioner of Taxation*.
>
> The amendments will provide further statutory support for the Court's judgment, and will be consistent with the established application of the PRRT law. As such, this measure has no revenue impact.[10]

1.36 ExxonMobil has stated that it would prefer to exhaust its legal options in the court system. A media report after the Budget announcement stated:

> ExxonMobil said it was premature of the Government to change the law given it had yet to decide whether to appeal against the Court's decision ...

9 Mr Stuart Brown, ExxonMobil, *Committee Hansard*, Canberra, 27 October 2011, p. 10.

10 The Hon. Wayne Swan MP and Senator the Hon. Penny Wong, *Budget Measures, Budget Paper No. 2, 2011-12*, 10 May 2011, p. 40.

> 'Obviously we are concerned about the timing of this announcement given that legal action is ongoing ... and we are reserving all of our rights in relation to this matter.'[11]

1.37 ExxonMobil has appealed the Federal Court's decision. The Federal Court's website lists a hearing in the Full Federal Court for the week commencing 7 November 2011.[12]

Phoenix activity

Introduction

1.38 So called phoenix activity refers to the actions of company directors or management who have deliberately sought to avoid paying liabilities, including taxation liabilities wages, superannuation and leave entitlements and a variety of other responsibilities, such as supplier accounts, through the use of contrived company liquidation.

1.39 Once formally liquidated, such companies resume trading through a new company structure controlled by the same person or group of individuals. Alternately, phoenix activity may be described as the use of the process of sequential company registration, liquidation and re-registration as a means of corporate fraud or tax evasion. A phoenix company may even be used to intentionally accumulate debts that the directors never intended to repay.

1.40 On occasion, phoenix operators may use family members or other associates to gain further benefits, such as inflated incomes or credit claims. There are cases where a family member or associate of a phoenix company director may be the commanding or controlling agent behind the company.

1.41 Phoenix activity is conducted for personal enrichment or gaining an unfair competitive advantage. It invariably constitutes a gross and unprincipled abuse of the corporate form and the long established privilege of limited liability which is of essential importance to our economic system. It undermines the integrity of corporate regulation. It deprives the Commonwealth of revenue. It reduces public trust in the economic system, lowers the reputation of business and potentially deters investors.

11 Mr Perry Williams, 'ExxonMobil comes out swinging' *The Australian Financial Review*, 12 May 2011, p. 19.

12 Federal Court of Australia, 'Appeals and Related Actions in the Federal Court', <http://www.fedcourt.gov.au/ctlists/ctlists_appeals.html> viewed 17 October 2011.

It also confers an unlawful benefit on those who evade the law and a disadvantage to those who comply with it.

1.42 In cases where phoenix activity involves the evasion of superannuation liabilities, it deprives workers of their financial security in old age, potentially contributes towards the creation of otherwise unnecessary welfare dependence and frustrates the efforts of successive governments to ensure the highest possible standard of living for Australians in their retirement.

1.43 The failure of phoenix companies to pay employees' entitlements or tax liabilities enables them to offer lower prices for goods and services. They can either reinvest money that compliant businesses would have to allocate to tax and superannuation payments or simply disburse this as profit or wages to the principals behind the phoenix scheme.

Reports and reviews

1.44 Almost a decade ago, the Royal Commission into the Building and Construction Commission (The Cole Commission) was concerned about the frequency of phoenix activity in the building industry. The Commission made a number of recommendations addressing this issue, including that:

> The Commonwealth, after consultation with the Australian Securities and Investments Commission, consider the need for an increase in the maximum penalties provided in the *Corporations Act 2001(C'wth)* for offences that may be associated with fraudulent phoenix company activity.[13]

1.45 The Commission also called on the Commonwealth to consider the need to amend existing legislation in order to disqualify company directors guilty of fraudulent phoenix activity.[14]

1.46 Several years ago, Treasury estimated that phoenix activity cost the federal revenue about $600 million per annum.[15]

1.47 The subject of phoenix activity has been pursued by Parliament on a number of occasions in recent years. For example, the Joint Committee on

13 *Final Report of the Royal Commission into the Building and Construction Commission* (2003), Recommendation 108," Summary of Findings and Recommendations", p. 110.

14 *Final Report of the Royal Commission into the Building and Construction Commission* (2003), Recommendation 109," Summary of Findings and Recommendations", p. 111.

15 Mr Nick Sherry (then Assistant Treasurer) *Crackdown on Phoenix Activity*, a press release of 13 November, 2009.

Public Accounts and Audit were advised in 2009 by the ATO that the incidence of phoenix activity was increasing: since 2008 the ATO employer obligations program had identified 6,013 companies as being a high-risk of defaulting on their obligations; of these over 4,600 had not complied with their PAYG withholding obligations and almost 3,000 had not met their super guarantee obligations.[16]

1.48 At that time the ATO explained the difficulty of prosecution because:

> ...in the early-2000s we obtained a number of high profile successful prosecutions, but after a few years we found that the penalties that were imposed on people who were successfully prosecuted became ineffective. We went from people getting custodial sentences to people getting home detention, which included a provision that allowed them out during daylight hours to conduct business, so there was essentially no penalty. I think that led to a loss of confidence and a loss of interest, to some extent. When you are dealing with the court system and the Director of Public Prosecutions, they have an enormous caseload of very serious cases. It is hard to get cases up when their assessment is that the penalty is likely to be a slap on the wrist.[17]

1.49 In March 2010 the Inspector-General of Taxation (IGT) published a report, *The Review into the ATO's administration of the Superannuation Guarantee Charge*. In this report he found that insolvent employers were responsible for approximately $600.8 million owed to the ATO under the superannuation guarantee charge (SGC) and that most of this debt had been written-off as lost employee retirement savings.[18]

1.50 The report also found that the groups most effected by the problem were employees of micro businesses, contracted and casual employees, younger employees; and employees in particular sectors — the arts and recreation services; the transport, postal and warehousing sectors; accommodation and food services; and the agriculture, forestry and fishing sector. The mean salary and wages across each of these high risk segments is less than $30,000 a year, which indicated that those most at risk of having

16 Mr Mark Konza, Deputy Commissioner, Small and Medium Enterprises, ATO, *Joint Committee of Public Account and Audit, Biannual Hearing with the Commissioner of Taxation: Hansard*, Friday 23 October 2009 pp. 8-9 and Mr Bruce Quigley, Second Commissioner, ATO, *ibid*, pp. 26-27.

17 Mr Mark Konza, Deputy Commissioner, Small and Medium Enterprises, ATO, *Joint Committee of Public Account and Audit, Biannual Hearing with the Commissioner of Taxation: Hansard*, 23 October 2009, Friday 23 October 2009, p. 24.

18 The Inspector-General of Taxation, *The Review into the ATO's administration of the Superannuation Guarantee Charge: A report to the Assistant Treasurer,* March 2010, p. 3.

insufficient superannuation contributed on their behalf by employers were low-income employees.[19]

1.51 The IGT stated that he had received many submissions on the growing practice of employers misclassifying workers as subcontractors, rather than employees, to avoid paying superannuation.[20] In addition, over 70 per cent of complaints concerning superannuation guarantee obligations come from ex-employees. There was also anecdotal evidence to suggest that many employees are concerned that, if they query their employer about their superannuation guarantee entitlement or lodge a complaint with the ATO, then they could either lose their job or no longer be given work. [21] Finally, the IGT noted that:

> A delay in triggering ATO audit activity significantly increases the likelihood of non-payment of SGC debt (requiring more costly debt recovery action) and irrecoverability through insolvency. It also hampers the ATO's and government's efforts to maintain a level playing field amongst employers and ensure that compliant employers do not face a financial disadvantage against non-compliant competitors.[22]

1.52 The IGT recommended that the Government consider making company directors personally liable for the unpaid superannuation guarantee charge liabilities of their companies. [23]

Government consultations

1.53 On 14 November 2009 the Government released a proposals paper containing options to address such fraudulent phoenix activity.[24] The paper outlined a number of possible amendments to the taxation and corporations law to address the problem. These included the following actions in relation to taxation law:

19 The IGT, *The Review into the ATO's administration of the Superannuation Guarantee Charge,* March 2010, p. 4.

20 The IGT, *The Review into the ATO's administration of the Superannuation Guarantee Charge,* March 2010, p. 4.

21 The IGT, *The Review into the ATO's administration of the Superannuation Guarantee Charge,* March 2010, p. 5.

22 The IGT, *The Review into the ATO's administration of the Superannuation Guarantee Charge,* March 2010, p. 6.

23 The IGT, *The Review into the ATO's administration of the Superannuation Guarantee Charge,* March 2010, p. 14.

24 See *Action Against Fraudulent Phoenix Activity*, November 2009 and is available at: <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1647>.

- amending the director penalty regime to remove the ability of directors engaged in fraudulent phoenix activity to avoid personal liability for Pay As You Go (Withholding) (PAYG(W)) liabilities by placing the company into voluntary administration or liquidating the company;
- expanding the director penalty regime Expand the director penalty regime to apply to superannuation guarantee (SG) liabilities and other taxation liabilities such as indirect tax liabilities and a company's own income tax liability;
- amending the promoter penalty regime to ensure that the promoter penalty regime is able to target those individuals promoting fraudulent phoenix activity;
- expanding anti-avoidance provisions in the taxation law (either through an expansion of the existing general anti-avoidance rule (GAAR) or through the creation of a specific provision) to effectively negate any taxation benefit derived from fraudulent phoenix activity;
- reinstating the 'failure to remit' offence that would make it an offence for an entity not to remit the required PAYG(W) amounts;
- denying directors of companies (and potentially close relatives) from being able to access PAYG(W) credits in relation to their own income where amounts withheld have not been remitted (to the ATO) by the company;
- introducing an offence for claiming non-remitted PAYG(W) credits by making it an offence for directors to claim credits in relation to their own income for PAYG(W) amounts that have not been remitted by the company of which they are a director; and
- providing the Commissioner of Taxation with the discretion to require a company to provide an appropriate bond (supported by sufficient penalties) where it is reasonable to expect that the company would be unable to meet its tax obligations and/or engage in fraudulent phoenix activity.

1.54 The paper also identified the following options in the corporations law:

- expanding the scope for disqualification of directors by giving a Court or the Australian Securities and Investment Commission (ASIC) a discretion to disqualify a person from being a director if the relevant company has been wound up and the conduct of the person, as a director of that company, makes them unfit to be concerned in the management of a company;

- restricting the use of a similar name or trading style by successor company and making directors personally liable for the debts of a liquidated company in circumstances where a 'new' company adopts the same or similar name as its previous incarnation; and
- adopting the doctrine of inadequate capitalisation by allowing the corporate veil to be lifted where a company sets up a subsidiary with insufficient capital to meet the debts that could reasonably be expected.

1.55 Treasury received 28 submissions, 2 of which were confidential.

1.56 In their submission the Australian Institute of Company Directors supported the case for reform in relation to companies that fail to pass on PAYG deductions to the ATO. Apart from that, they did not believe that there was strong case for additional legislation. They opposed ASIC being awarded any additional powers to disqualify a director beyond that which it already has under section 206F of the Corporations Act. They wanted greater clarity concerning the use of similar names or trading style by successor companies and claimed that no case had been made for introducing the concept of 'inadequate capitalisation'.[25]

1.57 In their submission the Corporations Law Committee of the Business Law Section of the Law Council of Australia:

- strongly opposed the expansion of ASIC's power to disqualify a person from managing corporations by administrative action;
- strongly opposed the adoption of the doctrine of adequate capitalisation;
- stated that there was simply no need to extend the director penalty regime in the taxation law beyond PAYG deductions.[26]

1.58 The Insolvency and Reconstruction Law Committee of the Business Law Section of the Law Council of Australia took issue with the definitions involved in criminalising phoenix activity. They argued that not all phoenix activity was necessarily immoral or unethical:

> ...if one defines phoenix activity merely as the phenomenon by which a person or persons who have been controlling company A carry on the same or substantially the same business through

25 The Australian Institute of Company Directors, submission to the Treasury, December 2009. All of the submissions that were not confidential are available at: <http://www.treasury.gov.au/contentitem.asp?ContentID=1892&NavID=037>.

26 Law Council of Australia (Corporations Law Committee), submission to Treasury, November 2009, pp. 1-2.

> company B, often with the same or substantially the same name, following the demise of company A...[there will be] circumstances where this might happen quite legitimately – eg where a director buys the business, including the right to use the name, from the liquidator. [27]

1.59 The Insolvency and Reconstruction Law Committee argued that the concept could be defined by way of the intention of the parties or by way of the consequences. They suggested that sections 216-217 of the UK's *Insolvency Act 1986,* which restricts the re-use of a company's name after liquidation, might be relevant. They also suggested that thought needed to be given to protect the interests of innocent directors caught up unwittingly in phoenix activities.

1.60 The Committee argued against any amendment to the director penalty provisions which would make a company director automatically liable for unremitted withholding taxes 3 months (or any other period) after the date they should have been remitted. They were concerned that such changes might catch many directors not engaged in phoenix activity of any sort who may, for example, be reasonably engaged in proper attempts to restructure a company's affairs. In their view, such an amendment would not target the issue of phoenix activity with any precision. They also believed that the proposal would provide the ATO with an unwarranted advantage over other creditors.

1.61 In their submission, the Taxation Law Committee of the Law Council of Australia took the general view that existing legal remedies against fraud were sufficient to resolve the problem of fraudulent phoenix activity, but were not used as often as they should be:

> If relevant agencies established a track record of regularly prosecuting phoenix activity under existing laws, then the Committee believes the problem would be much smaller and the case for a further erosion of civil and economic liberties would largely vanish.[28]

27 Law Council of Australia (Insolvency and Reconstruction Law Committee), submission to the Treasury, March 2010, p. 2.

28 Law Council of Australia (Taxation Law Committee), submission to the Treasury, February 2010, p. 3.

Committee objectives and scope

1.62 The objective of the inquiry is to investigate the adequacy of both Bills in achieving their various policy objectives and, where possible, identify any unintended consequences.

Conduct of the inquiry

1.63 Details of the inquiry were placed on the committee's website. A media release announcing the inquiry and seeking submissions was issued on Wednesday 19 October 2011.

1.64 Eighteen submissions and seven exhibits were received. These are listed at Appendix A.

1.65 A public hearing was held in Canberra on Thursday 27 October 2011. A list of the witnesses who appeared at the hearing is available at Appendix B. The submissions and transcript of evidence were placed on the committee's website at http://www.aph.gov.au/house/committee/economics/index.htm.

2

Analysis of the Bills

Introduction

2.1 The two key areas examined during the hearing were the legislative provisions relating to the petroleum resource rent tax, and the director penalty regime to make directors personally liable for their company's unpaid superannuation guarantee amounts.

2.2 Schedule 2 of the Bill amends the *Petroleum Resource Rent Tax Assessment Act 1987* to provide certainty regarding how the 'taxing point' is determined for the purpose of the Petroleum Resource Rent Tax (PRRT). The committee examined the need for the legislation and, at the same time, heard evidence from certain groups which were opposed to the legislative proposals. This Chapter discusses the policy intent and merits of the legislation.

2.3 Schedule 3 of the Bill strengthens directors' obligations to cause their company to comply with its existing pay as you go (PAYG) withholding and superannuation guarantee requirements. In particular, the Explanatory Memorandum states that 'these amendments reduce the scope for companies to engage in fraudulent phoenix activity or escape liabilities and payments of employee entitlements.' The second section of this Chapter examines this proposal in detail and, in particular, concerns by relevant industry bodies that the legislation could lead to more onerous requirements for company directors.

Petroleum Resource Rent Tax

The original policy intent

Background

2.4 The Explanatory Memorandum to the Bills states that they are confirming 'how the PRRT has applied since commencement'. It summarised the Court's decision earlier this year as:

> The Federal Court rejected this narrow interpretation [of ExxonMobil], instead affirming the long established application of the PRRT in relation to the taxing point consistent with the policy intent.[1]

2.5 The Explanatory Memorandum states that, if ExxonMobil's interpretation were applied, a number of unintended consequences would arise:

- it would be more in the nature of a tax on production, which is inconsistent with the aim of the PRRT being a tax on profit;
- in many cases, the taxing point would occur earlier than the point at which the products are sold, meaning that a derived market value would be used to calculate the tax, which would increase complexity; and
- the scope of eligible petroleum projects subject to the tax would be artificially limited.[2]

2.6 In evidence, Treasury quoted the Explanatory Memorandum to the Bill for the 1987 Act when it was first introduced into the Parliament. Treasury's point was that the tax was always intended to be a profits-based tax that was to be calculated by reference to the returns that a company was receiving for the product. The original Explanatory Memorandum stated:

> The PRRT contains rules for determining the petroleum projects that are subject to the PRRT and specifies the basis on which the PRRT liability of each participant is to be calculated. Broadly the tax will apply to be excess, if any, of receipts over expenditure. It provides for any excess of expenditure over receipts for a year to

1 Hon. Mr Wayne Swan MP, Deputy Prime Minister and Treasurer, *Explanatory Memorandum*, 2011, p. 16.

2 Hon. Mr Wayne Swan MP, Deputy Prime Minister and Treasurer, *Explanatory Memorandum*, 2011, pp. 16-17.

> be compounded forward and identifies the receipts or, in the case of certain petroleum projects that have not been sold by the point at which they leave an on-site storage facility, amounts deemed to be receipts that are to be assessable for PRRT purposes.[3]

2.7 The Explanatory Memorandum for the 1987 Act, when it was presented to the Senate following Government amendments in the House, also confirms the profits approach. It states, 'The tax is to apply to profits from the recovery of petroleum in offshore areas' and, 'Unlike royalty and excise arrangements, the petroleum resource rent tax is profit-based, rather than being based on production'.[4]

Analysis

2.8 ExxonMobil did not dispute this high level policy intent, but they argued that the Tax Office initially had conflicting interpretations of the legislation. Further, ExxonMobil had raised this issue informally with the Tax Office shortly after entering the regime and formally raised it with the Tax Office in 1994 in relation to the 1991 year. ExxonMobil referred to a seminar paper presented by the Tax Office in 1992. The section on marketable petroleum commodities (MPCs) stated:

> Some of these products are further defined by reference to their gaseous mixture (eg sales gas – defined as a mixture that includes methane, where the methane comprises more than 50% by weight of the mixture). It is quite possible that some of these products, e.g. sales gas, could be produced on the platform in view of their definition. It has been suggested that an MPC does not become an excluded product until it is 'in fact', 'from a practical point of view' marketable. This is so, it has been suggested, even if the product has been further processed or treated, or has been moved beyond storage adjacent to the place of production (see 'excluded commodity', sec. 2). The Act does not ask when a commodity is in fact or from a practical point of view marketable. It defines an MPC and defines the point when that commodity becomes an excluded commodity. There is no room for the ATO to postpone the point at which an assessable petroleum receipt (or an exploration recovery receipt) is derived.[5]

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3 Mr James O'Toole, Treasury, *Committee Hansard*, Canberra, 27 October 2011, p. 2.

4 Senator the Hon. Peter Walsh, Minister representing the Treasurer, *Explanatory Memorandum*, 28 April 1987, p. 4.

5 *Exhibit 1*, p. 9.

2.9 Following the hearing, Treasury noted that the views presented at these seminars are not formal Tax Office views, but that they are designed to assist industry by giving an indication of how the Tax Office is likely to approach new law:

> This paper was for information purposes only and a common practice to explain early thinking on new legislation. It is well known that such presentations at seminars are done in good faith but are not binding technical ATO views (such as a binding ruling). It was in no way a fully considered general view and definitely not a fully considered view for the Esso/BHP particular fact circumstances.[6]

2.10 ExxonMobil also noted that an opposite view was put to BHP by the Department of Primary Industries and Energy at the time.[7] Treasury provided evidence that ExxonMobil was itself not consistent in how it viewed the law during the early stages of the tax and that it favoured the later taxing point when this was to its benefit during a commercial dispute with the buyers of its products:

> At this time there was a commercial dispute between Esso/BHP and its buyers (including Victorian State Authorities) dealing with whether the PRRT imposed on Esso/BHP in respect of the gas sold to the buyers, could be passed on to the buyers (the 'pass-on' dispute).
>
> At the arbitration the State Government raised the taxing point issue in its submission, arguing that the amount of PRRT, if it could be passed on, was incorrectly calculated as the appropriate Taxing Point was at an earlier point than that contended for by Esso. Esso contended (in contrast to their position in the recent Federal Court case) that the appropriate taxing point was at the exit from Longford and had lodged its PRRT returns on that basis. This contention is consistent with the long-standing ATO view.[8]

2.11 The committee also questioned ExxonMobil on why it took 10 years for the company to commence its court case on this matter, because this delay could be interpreted as their agreement with the legislation. They replied:

> ... there were a number of issues around the application of PRRT to Bass Strait that had to be resolved, initially. And the first focus was on the most valuable product stream, which was crude oil and

6 Treasury, *Submission 17.1*, p. 4.

7 Mr Stuart Brown, ExxonMobil, *Committee Hansard*, Canberra, 27 October 2011, p. 10.

8 Treasury, *Submission 17.1*, p. 5.

> how you value crude oil. That was the biggest dollar-value dispute ...
>
> There were other issues around what costs were deductable and all this time the sales gas issue was going on. Especially in those early years, the value of sales gas was very low; the gas price was very low. So the revenue at stake, looking at the whole scheme of things, was not that big.[9]

2.12 In summary, ExxonMobil did not commence legal action until 2004 because they prioritised their tax issues on a commercial basis. They also stated that they filed conservatively because there were no precedents for how gas would be treated:

> At that stage there was no interpretation. Remember that the PRRT was introduced in 1987. The first taxpaying project was an oil project in 1989. There was no sales gas subject to tax until the Bass Strait project came in ... Right through that time there were differing views around the industry and in the ATO. In one office in the ATO there were clearly differing views, so we took the most conservative approach at that point and filed conservatively.[10]

2.13 The view of ExxonMobil is not necessarily representative of the general view of industry. In evidence, Treasury stated that, 'the small number of other taxpayers are operating in line with the current understanding of the law and the effect of the amendment'.[11]

Conclusion

2.14 The committee notes that ExxonMobil has disputed the Tax Office's interpretation of the law. The policy intent of the Act, that it is to implement a profits based tax, has always been clear. Further, this is how ExxonMobil filed its tax returns, this is how other taxpayers are operating, and it is how the Tax Office has administered the Act.

2.15 Under these circumstances, the committee believes that it is appropriate for the Parliament to affirm the policy intent of legislation as implemented in the Bills.

9 Mr Stuart Brown, ExxonMobil, *Committee Hansard*, Canberra, 27 October 2011, pp. 13-14.

10 Mr Stuart Brown, ExxonMobil, *Committee Hansard*, Canberra, 27 October 2011, p. 9.

11 Mr Paul McCullough, Treasury, *Committee Hansard*, Canberra, 27 October 2011, p. 6.

Retrospectivity

Background

2.16 The Bills apply the new definition of a marketable petroleum commodity back to 1990. Tax and business groups consistently made the point in submissions that the definition should only apply prospectively, either from the date of assent of the Bills or from the announcement in the 2011 Budget.[12]

2.17 Some of the more specific points made by business and tax groups were that:

- retrospective amendments are usually only made either to the benefit of taxpayers or to address tax evasion;[13]
- clarifying amendments usually operate prospectively;[14]
- retrospective amendments are permitted to resolve undue hardship, due to unintended applications to particular taxpayers; and
- retrospective amendments are permitted where a court's decision is totally unanticipated by all parties and it changes a common understanding of the law.[15]

Analysis

2.18 The committee's view is that legislation should be as fair as possible and that the extent to which it generates certainty for the community is also a tangible benefit. Legislating retrospectively should not be done lightly because it is very easy for it not to be fair and for it to create uncertainty. Decisions about retrospectivity must be made on a case by case basis.

2.19 As Treasury advised the committee, it is important to note that the legislation has been in place and has operated in line with the amendments back to the date at which they are deemed to commence. ExxonMobil and BHP and other companies have paid tax as if according to the amendments and the Tax Office has also administered the law as if

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12 For example, the Law Council of Australia, *Submission 3*, p. 1; ICAA, *Submission 10*, p. 2; the Business Council of Australia, *Submission 2*, p. 1; the Australian Petroleum Production and Exploration Association, *Submission 1*, p. 3.

13 Mr Stuart Brown, ExxonMobil, *Committee Hansard*, Canberra, 27 October 2011, p. 12.

14 Mr Yasser El-Ansary, ICAA, *Committee Hansard*, Canberra, 27 October 2011, p. 20; Ms Teresa Dyson, Law Council of Australia, *Committee Hansard*, Canberra, 27 October 2011, p. 22.

15 Law Council of Australia, Submission 3, p. 2.

in accordance with the amendments. This is also consistent with the policy intent of the PRRT.[16]

2.20 In evidence, the Law Council of Australia stated that the Parliament should have enacted affirming legislation, 'many, many years ago'.[17] However, a similar argument could be put to ExxonMobil. It had the opportunity to litigate in the 1990s, but did not do so, with the result that the disputed tax amount grew over time. In fact, Treasury advised that ExxonMobil only started litigation when the Tax Office stated that it would determine the objections on the information at hand.[18]

Conclusion

2.21 The Bills do not create a new tax burden for ExxonMobil and BHP. Rather, they affirm the original legislative intent of the PRRT. Therefore, the Bills do not generate the type of uncertainty and unfairness that is the underlying concern behind retrospective legislation.

Sovereign risk

Background

2.22 During the inquiry, the Tax Institute, the ICAA and ExxonMobil argued that the Bills, through their retrospective application, increased sovereign risk and that Australia would be a less attractive place in the long term for international capital.[19]

2.23 At the hearing, ExxonMobil explained how the tax environment affects large scale investment decisions:

> ... resource projects in general tend to be so large that they take many years for the investment, the construction and the actual setting-up of the operation to take place. Once you hit the 'go' button, it takes that number of years before you have a producing entity. If you are a third of the way through that investment and someone changes the rules, someone changes the tax environment, you have two choices: you keep going, on the basis that going forward and actually starting the operation up is better than

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16 Mr Paul McCullough, Treasury, *Committee Hansard*, Canberra, 27 October 2011, p. 2.

17 Ms Teresa Dyson, Law Council of Australia, *Committee Hansard*, Canberra, 27 October 2011, p. 22.

18 Treasury, *Submission 17.1*, p. 6.

19 Tax Institute, *Submission 4*, p. 2; ExxonMobil, *Submission 7*, p. [7]; ICAA, *Submission 10*, p. 2.

> stopping and writing off all the investment that you have made, or you stop. Once people have hit the 'go' button, you will find that these investments will keep getting made, but, just like in the tax return aspect of this, there is a lag in the investment confidence here. So the rule you make today will affect decision making about projects that may not start for another two or three years, which then have a four- or five-year investment ramp-up. So there is a substantial lag in this. I cannot sit here and tell you that, as a result of making one law change today, tomorrow doomsday will happen. It just does not work that way. But the setting in which people will view investments going forward will be different.[20]

Analysis

2.24 The committee acknowledges that tax laws are relevant to the investment decisions of multi-national corporations and that the Parliament needs to be mindful of how its legislation presents Australia in the global marketplace.

2.25 There are two aspects to sovereign risk in this inquiry. The first is in relation to retrospectivity, which has been discussed earlier. The second covers the rate at which changes are made, with more rapid changes increasing uncertainty for investors.

Conclusion

2.26 In this case, the committee is of the view that the Bills do not increase the sovereign risk of making long term investments in Australia. The Bills affirm the long term policy intent of the PRRT and do not impose any new tax burden.

2.27 Within this context, the Bills do not represent an unstable, or constantly changing tax framework that reduces the attractiveness of Australia as an investment destination.

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20 Mr John Dashwood, ExxonMobil, *Committee Hansard*, Canberra, 27 October 2011, p. 15.

Phoenixing

Consensus against the practice

2.28 There was a very strong consensus amongst submissions and witnesses that fraudulent phoenix activity was abhorrent and that the non-payment of employee superannuation was inexcusable. It was also agreed that these had serious implications for the reputation of business, public confidence in the ability of the law to protect property rights and the ability of the current generation of Australian workers to provide themselves with a high income and high level of independence in retirement. As the Council of Small Business of Australia (COSBOA) stated at the public hearing, the behaviour of those company directors involved in fraudulent phoenix activity:

> ... is appalling and it makes it hard for everybody else in business. It is not just the fact they are doing it which is wrong—and it is wrong—but they are making it harder for everybody else, giving us a bad reputation and creating the opportunity for bad press. I think we need to spend more time chasing those people rather than chasing everybody and making life difficult for everybody.[21]

2.29 There was also much agreement that phoenixing was the result of deliberate moral choices and that it required a certain degree of malicious intent for any company to fail to pay an employee's superannuation.

Limiting the scope of the Bills to phoenix operators

Background

2.30 An issue that was raised by those who believed that the Bills affects all company directors, when in fact only a minority of company directors were responsible for either fraudulent phoenix activity or the non-payment of employee superannuation in the first place.

2.31 The Australian Institute of Company Directors put it to the committee at the public hearing:

> What we are very concerned about at the Australian Institute of Company Directors is that this legislation, which is apparently targeted at the phoenix company activity which is already subject

21 Mr Peter Strong, COSBOA, *Committee Hansard*, Canberra, 27 October 2011, p. 43.

> to ASIC overview in a very significant fashion, impacts on all directors of all companies throughout Australia—over two million, in fact, in relation to that.[22]

2.32 Similar concerns were raised by COSBOA, who stated: 'We are punishing innocent people for the behaviour of a few guilty people.' [23]

2.33 The ICAA shared this perspective, but proposed the following remedy; that the Committee should consider recommending to the Government that they allow the Commissioner of Taxation:

> ...to by-pass the requirement to issue a director penalty notice in circumstances where:
>
> - an employee entitlement amount is unreported and unpaid for a period of three months or more, and
> - any of the relevant directors or the corporation have a history (over the course of the last five/ten years) of prior involvement in:
>   - ⇒ fraudulent phoenix activities, or
>   - ⇒ a corporation that entered into external administration for reasons of insolvency.
>
> Where these conditions are not met, the legislation should continue to prescribe a requirement on the Commissioner to issue a 21-day notice prior to the commencement of director penalty recovery proceedings.[24]

Analysis

2.34 It is important to note up front that the Bills extend PAYG to those who do not meet the burdens of existing superannuation requirements. The committee rejects that it increases the burden. Rather, it more effectively enforces current obligations by extending the penalty regime for PAYG to superannuation.

2.35 The ATO has already identified likely targets under the Bills. The ATO explained that, according to their best estimate, at any given time there are around 6,000 phoenix companies operating in Australia and that between 7,500 and 9,000 company directors could be exposed to liabilities by the proposed legislation.[25]

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22 Professor Bob Baxt, AO, Australian Institute of Company Directors, *Committee Hansard*, Canberra, 27 October 2011, p. 32-34.

23 Mr Peter Strong, COSBOA, *Committee Hansard*, Canberra, 27 October 2011, p. 43.

24 ICAA, S*ubmission 10*, p. 4.

25 Mr Grant Darmanin, ATO, *Committee Hansard*, Canberra, 27 October 2011, pp. 32-34.

2.36 The effectiveness of the ATO's compliance model was supported in testimony from the small business sector who noted that:

> The tax office has its benchmarking. It is a very simple device that takes the honest ones of it, basically—you'd have to say they're honest—and identifies those who may be dishonest. Then the tax office sends them letters et cetera and chases them up. I think about 12 per cent of all businesses end up outside its benchmark. They have a fabulous system, and I think they could apply something similar around the phoenix companies and the other sorts of companies.[26]

2.37 On the other hand, the committee recognises that it can be prudent to limit legislation, rather than relying on administrative discretion, to ensure that there are no unintended consequences and that company directors who act in good faith are not caught by the provisions. Such an amendment, if possible, would provide confidence to compliant directors that they will not be inadvertently subject to these provisions.

Conclusion

2.38 The provisions in the Bills do not add to existing requirements, but instead apply a more effective penalty regime to phoenix operators who are abusing the law to obtain an unfair competitive advantage.

2.39 However, the committee notes concerns from the business community and its representatives that the Bills potentially apply to the broad range of directors whether engaged in phoenix activity or not. The committee recommends that the Government should investigate whether it is possible to tighten the provisions of the Bills to better target phoenix activity.

Recommendation 1

2.40 **The Government investigate whether it is possible to amend the Bills to better target phoenix activity.**

26 Mr Peter Strong, COSBOA, *Committee Hansard*, Canberra, 27 October, 2011, p. 45.

Penalties and defences

Background

2.41 Another objection to the bills was that in their present form they reverse the onus of proof and assume the guilt of company directors, rather than extend the presumption of innocence. This argument was made by Australian Institute of Company Directors in their submission.[27]

2.42 Witnesses from the Institute expanded on this point at the hearing. They noted that, although the Bills do not introduce a strict criminal liability, they make it more difficult to be a company director in a climate where strict criminal liability is becoming more accepted.

> Whilst the legislation does not introduce strict criminal liability...it very definitely impacts on a critical area that the federal government, through Senator Nick Sherry, is leading the charge on in relation to a review of all legislation, over 700 pieces of legislation, in Australia that create strict liability regimes, putting the onus of proof on directors to show that they are innocent rather than the Crown or the regulator having to prove that they are guilty. I firmly believe, despite the fact that I was chairman of a regulator for three and a bit years, that we should not depart from the principle that a person is innocent until proven guilty. But we seem to be absolutely abandoning that almost willy-nilly.[28]

Analysis

2.43 At the hearing, Treasury's response to these concerns about the onus of proof and the penalty regime was that the bills did not contain any innovation or novel development, but that they simply extended the scope of the existing system:

> ...it is not a whole new regime; it builds on an existing regime, the director penalty regime. In terms of wider exposure to directors, the only wider exposure in respect of an existing regime is that it also is proposed that it applies to super guarantee debts as well ... it is more an existing regime and an additional debt has been inserted into the director penalty regime—that is, the super guarantee.[29]

27 Australian Institute of Company Directors, *Submission 10*, p. 2.

28 Professor Bob Baxt, AO, Australian Institute of Company Directors, *Committee Hansard*, Canberra, 27 October 2011, p. 36.

29 Mr Haydn Daw, Treasury, *Committee Hansard*, Canberra, 27 October 2011, p. 27.

2.44 Furthermore, key changes to the director penalty regime in the bill were specifically designed to close loopholes in the existing system which enables fraudulent phoenix activity. For example, the removal of the 21 day notification period is essential to frustrate contrived insolvencies designed to allow directors to walk away from their obligations.

2.45 As the ATO advised about the directors of fraudulent phoenix directors:

> The way they currently operate...is to wait until they get a direct penalty notice and then put their company into administrational liquidation within 21 days, essentially wiping their hands of that formal liability. They start a new company and carry on the same business again. That is the reality.[30]

2.46 In the view of the Treasury, the current recovery rules concerning the 21 day notice actually impedes the collection of the liabilities, because unscrupulous directors can undermine the regime by going into liquidation soon after the notice is issued, thereby leaving a trail of debts behind them. These debts are difficult to recover. Furthermore, it is only after employees or ex-employees commence claiming their tax credit entitlements at year's end that any fraudulent activity by company directors comes to light. The bills seek to retrieve this situation.

2.47 The ATO also pointed out that the existing regime has defences for directors so that they are not inadvertently swept up. These defences remain available to directors under the Bills. For example, the defences for director penalties include illness or some other reason such that it would be unreasonable to expect a director to take part in the management of a company at the relevant time, or if the director took all reasonable steps to ensure that a company complied with its obligations.[31]

2.48 Although these defences appear reasonable in the first instance, the Australian Institute of Company Directors gave an example of how they might not protect directors:

> Let’s assume you have a difficult issue in accounting principles or some difficult question where the director, not being an expert, feels, ‘I have to go and get expert advice.’ They get expert advice which turns out to be wrong. They have relied on it, and we have just been told by Justice Middleton in the Centro case that there are some areas where, despite the fact that you go and get that advice, you are still going to be liable. In that situation what more

30 Mr Grant Darmanin, ATO, *Committee Hansard*, Canberra, 27 October 2011, p. 31.

31 See item 6 in the Tax Laws Amendment (2011 Measures No. 8) Bill 2011.

> could the director have done? Yet that director is going to be the person that is going to have to carry the onus of the penalty.[32]

2.49 Given the concerns expressed by industry, the committee believes that it would be appropriate for the Government to investigate whether it is possible to expand the definitions in the Bills. It may also be possible to work through some more factual scenarios to determine how the proposed defences would work in practice.

Conclusion

2.50 The committee is not convinced that the bills reverse the onus of proof or undermine established principles of natural justice. They simply extend the penalty provisions that already apply to PAYG to superannuation.

2.51 However, given the concerns expressed by industry at the hearings in relation to how the defences would operate in practice, the committee believes that it would be worthwhile for the Government to investigate this matter further and determine whether it would be possible to expand and strengthen the defences for company directors.

Recommendation 2

2.52 **The Government explore whether to expand and strengthen the defences for company directors available in the Bills.**

Small business

Background

2.53 The special needs of small business figured prominently in the responses to the proposed bill, in particular the limited capacity of small businesses to cope with the growing complexity of what is already a very complex taxation system. The ICAA made this point as follows:

> ...the small- to medium-sized enterprise market is typically the component of the taxpaying community that often struggles with the challenges of complying with what is fundamentally a very complex tax system and significant complexity around the administration of the tax system as well, quite aside from the

32 Professor Bob Baxt AO, Australian Institute of Company Directors, *Committee Hansard*, Canberra, 27 October 2011, p. 40.

> application of the revenue law itself. This is mostly because SME market businesses often find themselves in a position where, if they are fortunate enough to be in a growth market they may well be expanding at quite a significant rate of growth, but at the same time their processes, their level of sophistication in terms of their capacity to interpret and apply the complexities of the tax system as it begins to become more clunky and more cumbersome the bigger they are do not necessarily correlate together very well.[33]

2.54 COSBOA argued that the bill imposed a degree of complexity that a great many small business directors would not be able to manage effectively.[34]

Analysis

2.55 The committee reiterates its earlier comments. Firstly, the Bills do not impose new obligations on companies and their directors. Obligations in relation to superannuation remain the same. What the Bills do is to impose more effective penalties on company directors that do not meet their obligations and seek to avoid their superannuation responsibilities.

2.56 The ATO advised the committee at the hearing that the current system operates in order to encourage the engagement of the business community. Companies that are concerned about creating a liability for themselves only have to contact the ATO to receive assistance:

> The super guarantee system is a self-assessment system, so employers do not need to report to us that they have made payments. This encourages engagement because if a director ensures that the company reports its obligation within three months after the due date, the director avoids being personally liable. It encourages that engagement and lets us know what the liability is. Then we can pursue the company or pursue the director via the 21-day director penalty notice.[35]

2.57 The accessibility of the ATO and its success in working with small business and communicating with clients was substantiated by testimony from COSBOA. At the hearing COSBOA testified that in their experience the ATO:

> ...do not want to make it too complicated for small business, and that is what we are talking about, and many small businesses are

33 Mr Yasser El-Ansary, ICAA, *Committee Hansard*, Canberra, 27 October 2011, p. 24.

34 Mr Peter Strong, COSBOA, *Committee Hansard*, Canberra, 27 October 2011, pp. 43-44.

35 Mrs Geraldine Panfilo, ATO, *Committee Hansard*, Canberra, 27 October 2011, p. 28. Mrs Panfilo's testimony on this point is further elaborated on pp. 30 -31.

> on boards. They are our agency of choice. They are very good at communicating with small business and they are very good at trying to make their processes simpler.[36]

2.58 Further, the committee notes that it has already made recommendations that the Government should investigate whether the Bills should be tightened to focus only on phoenix operators and to explore whether the defences should be expanded.

Conclusion

2.59 The burdens in relation to small business are overstated. The administrative demands of superannuation are contained in existing law which SMEs can manage, especially given the focus of the ATO in engaging with small business. Finally, the committee expects that the Government will further explore whether it is possible to amend the Bills to better target phoenix operators and widen the defences for directors.

Volunteer and non-profit sector

Background

2.60 The possibility that the bills might inadvertently have a negative impact on the directors of the volunteer and non-profit sector was also raised during the committee's hearings. The assumption underlying such concerns was a significant proportion of the sector's directors lacked the capacity to cope effectively with the responsibilities imposed by the bill. COSBOA, in particular, stated this at the hearing.[37]

Analysis

2.61 Following the hearing the Treasury provided a submission clarifying the situation regarding volunteer organisations and the non-profit sector and the claims about their alleged vulnerability under the Bills. Treasury have advised the committee that the existing director penalty provisions only apply to the directors of companies registered under the *Corporations Act 2001*. The amendments in the Bills would not change that application.

2.62 Clubs and associations are mostly incorporated under the incorporated associations legislation in the various states and territories. Since clubs, sporting associations and not-for profits are generally not run as

36 Mr Peter Strong, COSBOA, *Committee Hansard*, Canberra, 27 October 2011, pp. 45-46.

37 Mr Peter Strong, COSBOA, *Committee Hansard*, Canberra, 27 October 2011, pp. 43-44.

companies under the *Corporation Act 2001*, the director penalty provisions and proposed changes will not alter their status, obligations and potential implications.[38]

Conclusion

2.63 It is clear to the committee that there is considerable confusion about the status and responsibility of directors in the voluntary and not for profit sectors. This is a very serious concern, given the implications for the individuals involved and the wider community that so selflessly serve. However, given the advice of Treasury on the matter, there is no reason to believe the bill has any negative implications for the sector. The committee welcomes this advice.

Summary

2.64 The committee notes the concerns expressed by business about the impact of the Bills on company directors. However, the committee also notes the severity of the conduct that causes employees to lose millions of dollars in superannuation annually. The Textile Clothing and Footwear Union of Australia gave the example of a company that was placed in liquidation, owing $500,000 in employees' entitlements, of which $135,000 was superannuation. Its only secured creditor was a company whose directors were the same directors as the insolvent company. A further company, controlled by a relative of the first company, started up operations on the same premises and employed some of the original employees, all of whom were unable to recover a significant proportion of the superannuation, including voluntary contributions.[39]

2.65 In evidence, Treasury noted that there are companies that offer a speedy voluntary liquidation service if you are a company director and have received a penalty notice.[40]

2.66 The committee asked the Tax Office in evidence what a business would have to do in order to not meet their legal obligations in relation to superannuation:

> The corporate employer is required to pay nine per cent of the salary and wages into the employee's superannuation fund by the 28th day after the end of a quarter. If they fail to do so or if they

38 Treasury, *Submission 17*, p. 1.

39 Textile Clothing and Footwear Union of Australia, *Submission 16,* pp. 3-4.

40 Mr Michael Bradshaw, Treasury, *Committee Hansard*, Canberra, 27 October 2011, p. 31.

> underpay then they need to lodge a super guarantee statement with the tax office by the 28th day of the second month at the end of the quarter. That is the current law. That is the obligation as it stands. If they then do not lodge that statement and for us to penalise the director personally that statement has not been lodged for a further three months—so we have not received notification of the liability and they have not reported their obligation to the tax office. In effect, it is five months from the end of the quarter.[41]

2.67 Their obligations for the next quarter would have already arisen by this time as well.

2.68 Compared against the severity of this conduct, there are many different ways in which compliant directors can manage their superannuation obligations. In evidence, the Tax Office explained that directors could simply get the company to pay the required amounts and that would thereby extinguish their liability. If a company had cash-flow problems and could not pay the whole amount up-front, they could still extinguish the director's personal liability by entering into a payment arrangement.[42]

2.69 In their testimony at the hearing, the Tax Office stated that the system is designed to encourage business to approach them if problems arise:

2.70 The super guarantee system is a self-assessment system, so employers do not need to report to us that they have made payments. This encourages engagement because if a director ensures that the company reports its obligation within three months after the due date, the director avoids being personally liable. It encourages that engagement and lets us know what the liability is. Then we can pursue the company or pursue the director via the 21-day director penalty notice.[43]

2.71 On the other hand, almost all phoenix operators do not report, do not lodge, and do not pay.[44]

2.72 Given the severity of phoenixing, the fact that the Tax Office has a track record of working with compliant taxpayers and encourages engagement with taxpayers, the committee is of the view that the Bills show great potential in striking a reasonable balance between the interests of the victims of phoenixing, many of whom are low income earners, and

41 Mrs Geraldine Panfilo, ATO, *Committee Hansard,* Canberra, 27 October 2011, p. 34.
42 Mrs Geraldine Panfilo, ATO, *Committee Hansard*, Canberra, 27 October 2011, p. 28.
43 Mrs Geraldine Panfilo, ATO, *Committee Hansard*, Canberra, 27 October 2011, p. 28.
44 Mr Grant Darmanin, ATO, *Committee Hansard,* Canberra, 27 October 2011, p. 31.

compliant company directors. The committee has recommended that the Government investigate two refinements to the Bills, but the committee remains of the view that stronger legislation in dealing with phoenix operators will be required. The sooner this occurs, there will be more employees that receive their full superannuation amounts.

Overall conclusion

2.73 The committee supports the passage of the Bills. In relation to the Petroleum Resource Rent Tax (PRRT), the legislation provides certainty for how the taxing point is determined.

2.74 The committee notes that ExxonMobil disputes the Tax Office's application of the law from the start of the tax's application to Bass Strait in 1990-91 and that the Bill should not apply retrospectively back to that date. The committee received recommendations that it should apply prospectively from the date of announcement or the date of Royal Assent.

2.75 However, the committee rejects this position and concludes that the PRRT was always meant to be a profits based tax and that the Bill is not imposing a new tax burden, but that it is affirming the original policy intent of the legislation and the tax paid under it.

2.76 Schedule 3 of the Bill strengthens director's obligations to cause their company to comply with its existing pay as you go withholding and superannuation guarantee requirements. The committee supports measures in principle to deter companies from engaging in fraudulent phoenix activities.

2.77 The committee also notes that, for an employer not to comply with their employees' superannuation obligations under this Bill they must fail to carry out a number of legally required steps over a number of months. This goes beyond forgetfulness or oversight. Further, the Bills include a number of defences to protect company directors who act in good faith.

2.78 The committee received evidence that the provisions placed an increased burden on company directors. However, the provisions do not impose a greater burden because they already exist in relation to Pay As You Go within the tax system, where they operate successfully, and are being transferred across to superannuation. Business groups suggested to the committee that the Bills should be tightened to only focus on phoenix operators and the committee agrees that it would be worthwhile to investigate this possible refinement to give honest directors comfort they

will not be inadvertently targeted by the ATO. Similarly, the committee has recommended that the Government should investigate whether to expand the defences in the Bills.

2.79 To allow this to occur, the committee is of the view that the remainder of Tax Laws Amendment (2011 Measures No. 8) Bill 2011 should proceed and that Schedule 3 should be deleted from it. The Pay As You Go Non-compliance Tax Bill 2011 deals solely with phoenixing, so it should remain pending while the Government completes its investigations.

Recommendation 3

2.80 **The House of Representatives pass the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 after deleting its Schedule 3 and associated provisions. The Pay As You Go Non-compliance Tax Bill 2011 should remain pending the Government's investigations detailed in recommendations 1 and 2.**

Julie Owens, MP
Chair
2 November 2011

Appendix A – Submission and Exhibits

No.

1. Australian Petroleum Production & Exploration Association
2. Business Council of Australia
3. Law Council of Australia
4. Tax Institute
5. The Association of Superannuation Funds of Australia Limited
6. Australian Manufacturer's Worker's Union
7. Esso (ExxonMobil Australia)
8. Australian Institute of Company Directors
9. Housing Industry Association Ltd
10. The Institute of Chartered Accountants in Australia
11. Corporate Tax Association
12. Jones Partners Insolvency & Business Recovery Chartered Accounting
13. Australian Chamber of Commerce and Industry
14. Insolvency Practitioners Association
15. Confidential
16. Textile Clothing & Footwear Union of Australia
17. The Treasury

17.1 Supplementary Submission:

The Treasury

List of Exhibits

No.

1 Frank La Scala, Australian Taxation Office, 'Petroleum Resource Rent Tax: An Overview of the Legislation with Questions and Answers', Tax Workshop, 6 March 1992, Presented by ExxonMobil

2 Submission to the Department of the Treasury on Action Against Fraudulent Phoenix Activity. Strengthening incentives for Companies to comply with PAYG Withholding and Superannuation Guarantee, Presented by National Secretary, Dave Noonan

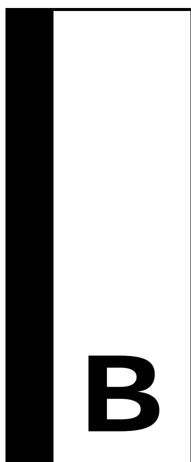
3 Inspector-General of Taxation, Review into the ATO's administration of the Superannuation Guarantee Charge, A Report to the Assistant Treasurer, March 2010, Presented by National Secretary, Dave Noonan

4 Race to the Bottom, Sham Contracting in Australia's Construction Industry, A report by CFMEU Construction and General , March 2011, Presented by National Secretary, Dave Noonan

5 Race to the Bottom, Sham Contracting in Australia's Construction Industry, A report by CFMEU Construction and General, March 2011, Full Report, Presented by National Secretary, Dave Noonan

6 The 2010 survey, entitled: The Impact of Legislation on Directors, Presented by Australian Institute of Company Directors

7 The 2008 survey, entitled: The Impact of Legislation on Directors, Presented by Australian Institute of Company Directors



Appendix B – Hearings and Witnesses

Thursday, 27 October 2011-Canberra

Department of the Treasury

Mr Paul McCullough, Secretary, Review of GST Distribution

Mr James O'Toole, Senior Adviser, Resource Tax Unit

Mr Richard Maher, Adviser, Business Tax Division

Esso Australia

Mr John Dashwood, Chairman

Mr Stuart Brown, Tax Manager

Institute of Chartered Accountants in Australia and the Law Council of Australia

Mr Yasser El-Ansary, Tax Counsel, ICAA

Ms Teresa Dyson, Chairman, Business Law Section, Taxation Committee, LCA

Department of the Treasury and the Australian Taxation Office

Mr Haydn Daw, Manager, Small Business and Trusts Unit, Treasury

Mr Michael Bradshaw, Senior Adviser, Treasury

Mr Grant Darmanin, Senior Director, Phoenix - Risk & Intelligence, ATO

Mrs Geraldine Panfilo, Director, Superannuation, ATO

Australian Institute of Company Directors

Professor Bob Baxt AO, Chairman, Law Committee

Mr Shayne Carter, Director, Greenwoods & Freehills Pty Ltd

Ms Leah Watterson, Senior Policy Adviser/Legal Counsel

Council of Small Business of Australia

Mr Peter Strong, Executive Director

Construction, Forestry, Mining and Energy Union (teleconference)

Mr Dave Noonan, National Secretary, Construction Division

Mr Tom Roberts, Senior National Legal Officer, Construction Division

Mr Ashley Hall, National Legal and Industrial Officer, Construction Division

Appendix C – List of advisory reports

Below is a list of advisory reports tabled by the House of Representatives Standing Committee on Economics in the 43rd Parliament.

No.

1. Inquiry into the Income Tax Rates Amendment (Temporary Flood Reconstruction Levy) Bill 2011; and the Tax Laws Amendment (Temporary Flood Reconstruction Levy) Bill 2011
2. Inquiry into Indigenous economic development in Queensland and advisory report on the Wild Rivers (Environmental Management) Bill 2010
3. Advisory report on the Taxation of Alternative Fuels Bills 2011
4. Advisory report on the National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Bill 2011
5. Advisory report on the Competition and Consumer (Price Signalling) Amendment Bill 2010 and the Competition and Consumer Amendment Bill (No. 1) 2011
6. Avisory report on the the Food Standards Amendment (Truth in Labelling - Palm Oil) Bill 2011
7. Advisory report on the Corporations (Fees) Amendment Bill 2011
8. Advisory report on the Tax Laws Amendment (2011 Measures No. 8) Bill 2011 and the Pay As You Go Withholding Non-compliance Tax Bill 2011