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Committee Secretary
Standing Committee on Economics
Parliament House
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AUSTRALIA
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Tax Laws Amendment (2011 Measures No. 8) Bill 2011 and the Pay As You Go Withholding Non-compliance Tax Bill 2011

The IPA is the professional body of company liquidators and bankruptcy trustees, and lawyers, financiers, academics and others concerned with insolvency law and practice. We welcome the opportunity to comment further on these proposed laws which are an important aspect of Australia's insolvency regime.

The IPA made a submission to Treasury on 15 January 2010 when these and other proposals were first raised in the November 2009 proposals paper.[1] The IPA made a further submission to Treasury on 2 August 2011 in response to a request for comment.[2] We refer back to those submissions.

In brief:

- we support the changes to the law in relation to director penalty notices, and the automatic liability that can apply. However we emphasise the benefit of some form of communication being sent to directors, prior to the liability under the automatic liability provisions being crystallised, still being used. Our practitioner members believe these notices give a real incentive to the director to seek early advice in relation to the company's financial difficulties. If automatic liability arises, without a notices being issued, we are concerned that directors who are already liable due to the operation of the law will have no incentive to take advice or take other remedial action. This will have the effect of allowing the company to continue to incur substantial debt which may have quite detrimental effect on creditors in general;

- we query some statements in the Explanatory Memorandum which focus on payment of a tax debt rather than on attention being given to the interests of all creditors through an insolvency appointment; and

- we query why GST is not included in this regime.

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[1] Action against fraudulent phoenix activity

[2] Exposure Draft - Tax Law Amendments to Strengthen Company Director Obligations and Deter Fraudulent Phoenix Activity, 5 July 2011

Usefulness of a penalty notice being given

The IPA supports in principle the tightening up of the director penalty notice (DPN) regime, including to allow for automatic liability without the necessity of a notice being served. Our main reason for suggesting that in our 15 January 2010 submission was that we considered that the ATO itself was not using the DPN notice effectively (the ATO had given reasons of lack of resourcing and other reasons for this), an automatic and less resource intensive process was seen as desirable.

We agree with the comments in the Explanatory Memorandum that the automation of the director penalty regime will encourage directors to address solvency issues earlier, and treat them more seriously. However service of a DPN has, in our members' experience, generally been an effective way to cause a director to face up to, not only the tax debt, but their company's solvency, and to then seek professional advice. Delay in seeking advice about a company's financial difficulties and dealing with its insolvency causes obvious problems.

Therefore, while a DPN need not necessarily be served on a director under this proposed law in order for personal liability to be imposed, we would encourage the continued use of such notices by the ATO where possible, not only to the registered office of the company but also to the personal address of the directors. This is because a DPN is a strong statement in writing, sent to the registered office and to the directors personally, which puts directors on notice that they must face up to their company's solvency. Other pressures or demands have often not been enough for the directors to act.

We also understand that, even if a DPN is not required to be issued, the ATO proposes to send a letter to the directors warning of their potential liability. We agree with that approach and such a letter could be seen in practice as a de facto penalty notice which would serve a similar purpose as a DPN. The main aim of the regime should be to incentivise directors to act properly – if the company is solvent, to pay the tax, if it is not, to take advice and, if the company is insolvent or likely to become so, to put the company into a formal insolvency administration.

We are concerned if automatic liability for the tax debt arises and can be recovered without any DPN needing to be served, the directors may well just continue to trade-on, adding to their liability, pending recovery or other action by the ATO. That is not a good outcome for the ATO or other creditors.

Statements in the Explanatory Memorandum as to the purpose of the penalty notice regime

More generally, we consider that this proposed law may be altering what was stated to be the original purpose of the DPN regime when it was introduced in 1993. That purpose was in fact to cause directors to seek early advice - to encourage directors "to face emerging problems as soon as possible"[3]. That advice, invariably from an insolvency practitioner, may be to put the insolvent company into formal insolvency whereby all creditors, including the ATO, would be dealt with equally.[4]

[3] Second Reading Speech, Hansard, Senate, 19 May 1993 at pp 879, 880, *Insolvency (Tax Priorities) Legislation Amendment Act 1993*, which abolished the Commissioner's priority for debts in relation to group tax and certain other unremitted amounts.

[4] On the other hand, a director who acted in response to a DPN merely by way of causing the insolvent company to pay the tax debt, without regard to other creditors, was acting wrongly because the ATO was being unfairly preferred: see *Browne v DCT* (1998) 82 FCR 1 and s 588FGA of the *Corporations Act*. We therefore do not understand the comment in the Explanatory Memorandum, at 3.246, that "the proposals may encourage companies to pay their tax and superannuation obligations ahead of debts to other creditors and once the company goes into liquidation there is less money and assets available for distribution to these other creditors".

This is stated in paragraph 1.3 of the draft Explanatory Memorandum, that the "policy objective of the director penalty regime is to ensure that directors cause their company to meet certain tax obligations or promptly put the company into liquidation or voluntary administration. This applies to all companies, not only fraudulent phoenix companies". But paragraph 3.15 of the draft Memorandum suggests that purpose of this proposed regime is largely to prompt payment to the ATO:

> Some aspects of the director penalty regime limit its efficacy in deterring fraudulent phoenix activity. Most notably, as directors are provided 21 days notice of the penalty before the Commissioner is able to commence proceedings to recover the liability, some directors 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.

Whether that explanation is confirmed in the proposed provisions, it does not acknowledge that the fundamental liability for company debts lies with the company, not the director. To suggest that it is unfortunate that placing the company into voluntary administration or liquidation thereby prevents personal liability being pursued against directors goes against the concept of the corporate veil. Indeed, it goes against insolvency policy because voluntary administration or liquidation should be the proper outcome of a company that becomes insolvent. Neither the directors nor the company should be preferring one creditor, the ATO or any creditor, if the company is insolvent.

We appreciate that a focus of the law is on unlawful phoenix activity but the draft Memorandum appears to focus too much on payment and less so on the importance of the insolvency options.

Other comments in the Explanatory Memorandum

We also make these other comments about the Explanatory Memorandum:

Phoenix activity

We do not disagree with the description of Phoenix activity whereby a "fraudulent phoenix company is used to intentionally accumulate debts and then is placed into voluntary administration or liquidation to avoid paying those debts". However the importance of the insolvency regime is downplayed in these comments. As we explained in our 15 January 2010 submission, insolvency laws provide perhaps the strongest mechanisms for recovery of assets unlawfully disposed of to defeat creditors. It is a matter of the means and the will to do that by way of the liquidator pursuing remedies available. If the company is without funds, we agree that no claims are generally pursued. Creditors, such as the ATO, can fund the liquidator, but this is not common.

The practical reality is, we concede, that many companies will enter insolvency with voidable or other unlawful transactions not challenged. That is not a deficiency of the insolvency laws but rather a fact of cost and time and risk in pursuing any legal claim.

Use of employee funds

We agree also that use of employee funds is treated by companies as part of the cash flow of a business. This in effect disguises the insolvency of the company, including from other creditors. In the experience of our members, accumulations of large unpaid tax liabilities are a common feature in many insolvencies in the present day. A purpose of the removal of the priority for tax debts in 1993 was to prevent this situation occurring. Prior to 1993 it was said that the ATO would not attempt to recover its debts because it ultimately had first claim on the company's assets in the event of insolvency to the detriment of other creditors. The removal of priority in 1993 which placed the ATO on the same footing as other creditors was supported by the insolvency profession, one reason being to prompt more timely recovery action by the ATO of its debts.[5]

Criminal penalties

As to criminal liabilities, we note that a company that fails to report is currently liable to criminal penalties. Section 8Y of the TAA 1953 allows directors to be pursued personally for such penalties and we note that this section is currently being reviewed as part of the Council of Australian Government's review of such provisions. The Memorandum may be incorrect in saying that it is not feasible to enforce such a penalty against a phoenix company once it goes into liquidation "with limited funds to pay such penalties". Penalties and fines are generally not a provable debt of a company in liquidation: *Corporations Act* s 553B.

GST

We also note that the Explanatory Memorandum says that phoenix operators often also avoid GST liabilities. In our members' experience, this is not an uncommon situation in many insolvencies. We therefore query why GST has not been included in this draft Bill.

Like employees' withholdings, GST moneys are also not those of the company, having been collected from the purchasers of the company's goods or services, for on-forwarding to the ATO. The company may decide not to pay the GST on time, or at all, and it may use those funds for other purposes. If GST were included, and a personal liability on directors imposed, we consider that there would then be an additional and serious incentive for directors to act earlier. This would also attend to those companies without significant numbers of employees but with high value sales. We note that nine of the 14 submissions made in response to the 2009 Treasury proposals paper, including the IPA, supported the inclusion of GST.[6] We also note that the government had indicated that indirect taxes were to be included in these reforms and that the government and the ATO have separately expressed concern about unremitted GST payments and are adopting means to address this.

If GST were to be included, we would welcome a further opportunity to comment on the proposed law changes.

Other laws

There are two other laws which we consider are relevant, on both of which the IPA made submissions and supported. We simply refer to them:

- The ATO has powers to demand security deposits from businesses to secure their likely or expected tax obligations. This is referred to in the Explanatory Memorandum at 3.202. This was to add to the powers of the ATO in dealing with phoenix activity. We assume that these powers are being exercised and are effective. We note that the ATO had issued only 10 security bonds as at 1 July 2011.[7]

- Improved communication and co-ordination of action between the ATO and ASIC is said to have been implemented through the *Tax Laws Amendment (Confidentiality of Taxpayer Information) Act* 2010 which allows the ATO to provide information to ASIC to assist ASIC in its regulation of phoenix activity. We assume that there are

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[5] ALRC 45, The Harmer report, [735]-[737]; Reminiscing the taxation priorities in insolvency [2005] JATTA 23, Symes.

[6] Regulation Impact Statement for Taxation Changes to Address Fraudulent Phoenix Activity - http://ris.finance.gov.au/

now communications between ATO and ASIC in relation to Phoenix activity and that these are having an impact.

IPA support

We note that the Explanatory Memorandum says [3.244] that the ATO may seek to raise awareness about the new laws including by contacting insolvency specialists and through consultative forums and seminars. The IPA works closely with the ATO in trying to ensure compliance with the insolvency and tax laws. We have always emphasised to our members the need to be aware of fraudulent phoenix activity, and the need to have directors deal with their company's insolvency promptly. The IPA will offer to assist the ATO in communicating with the profession and others about these changes if they become law.

Contact

We trust these comments are helpful. We would be pleased to discuss further if needed, in which case please contact the IPA's Legal Director, Michael Murray – 02 9080 5826 – mmurray@ipaa.com.au - as necessary.

Yours sincerely

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