11 November 2011

Committee Secretary
Senate Standing Committee on Economics
Parliament House
CANBERRA ACT 2600
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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.

Previous submissions

The IPA has made three submissions on this issue - a submission to Treasury on 15 January 2010 when these and other proposals were first raised in the November 2009 proposals paper; a further submission to Treasury on 2 August 2011 in response to a request for comment; and a further submission to the House of Representatives Committee on 26 October 2011.

This submission will focus both on the issue generally and on the more specific issue of honest directors and appropriate defences, these being particular issues for focus raised by the House of Representatives Committee. We refer back to some of our earlier submissions in this submission; if copies of them are required, please let us know.

Summary of IPA's views

In summary, we support the director penalty regime which has existed as integral to the insolvency law regime for nearly 20 years in providing an inducement for directors to properly respond to their company's insolvency. But IPA considers that the ATO should make more use of the DPN regime. There is in essence a misuse of what is employees' money, and the law should therefore extend the existing PAYG coverage to superannuation (and possibly GST). But there does need to be a clearer definition of phoenix activity – not all companies with unpaid tax and employee liabilities are phoenix companies.

In that regard, we consider that the need for a director to be served with a DPN should remain, even though it requires action by ATO to instigate the process, because it can stir a director to take proper insolvency action, and it does provide some fairness. But we suggest that some other 'one first and last chance' option be considered, based on existing policy approaches in the Corporations Act which we explain.

We also point out that under the insolvency laws, liquidators report significant phoenix activity to ASIC, which ASIC acknowledges and acts upon. We also note and support the new laws allowing great communication between ASIC and ATO about phoenix regulation.

The director penalty regime and insolvency

Directors' liability for their company's withholding taxes date back to 1993 when the Commissioner's priority in insolvencies was removed and replaced with the right of the ATO to impose liabilities for certain company taxes on directors personally.

A purpose of this was to give an incentive to directors to properly attend to the payment of employees' tax payments, and deter them from misusing those funds. The incentive and deterrent effect operates on directors in the same way as the threat of insolvent trading liability, except that it is more immediate – IPA submission 15 January 2010. A Director Penalty Notice (DPN) gives the director 21 days to attend to their company's tax debt, and or their company's insolvency.

Generally it is the view of our members that the current regime should be extended to superannuation guarantee charge (SCG) as well as GST obligations. We agree that companies that fail to remit these funds are receiving an unfair advantage over companies that comply with their obligations.

The DPN Regime when used by the ATO is effective in causing directors to seek professional advice in relation to their company's financial position and to take appropriate action. That action may be to voluntarily seek the appointment of a liquidator and have the company wound up, or to restructure the company's affairs via the appointment of a voluntary administrator, or to come to an arrangement to pay the company's outstanding liability to the ATO.

Unfortunately the ATO for reasons which have been unclear to us, as not been able to issue DPNs as promptly as needed where withholding taxes are not remitted. It may be more appropriate to enquire the reasons for this directly with the ATO than for us to make assumptions as to why this is the case. We understand it is due to the difficulty the ATO had in the timely issue of DPNs that the idea of an automatic liability arose – see IPA submission 15 January 2010.

Unpaid tax liabilities

Unpaid tax liabilities are often an indicator of insolvency, and given the nature of withholding tax liabilities, there is potential for their misuse.

The tone of the changes to these tax laws is that once a phoenix company goes into insolvency, nothing can be done to remedy the loss; and that a director is acting improperly by placing their insolvent company into insolvency. Neither is the case. For example, the House report says that phoenix 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*". That may be a reality but it is not necessarily the fault of or problem with the insolvency laws. The insolvency regime provides liquidators with strong remedies to investigate under compulsory powers and to recover business and other assets and refer breaches of the law. Like any legal remedy, this usually depends on moneys being available to bring such claims. If there are no moneys in the company, no government funding and no money provided by creditors, including the ATO, then recovery action cannot proceed. This is the crux of how phoenix activity occurs.

Our members report that the ATO is the major creditor in the majority of insolvency matters. However it should not be assumed that every insolvency involves phoenix activity as this is not the case. Therefore it could be argued the automatic liability provisions should only become applicable where there has been phoenix activity. For this to occur there needs to be a clearer definition of phoenix activity.

Phoenix activity in brief and ASIC's role

Our point is that phoenix activity, however defined, is essentially about the practical inability to enforce the legal remedies available under the insolvency and related laws. It is not the case that those remedies are necessarily inadequate.

However, whether there are funds or not, all insolvency practitioners are under an obligation to refer breaches of the law to ASIC or ITSA, and they do so. It is a matter for the regulators to pursue those breaches. In that regard, ASIC does provide liquidators with funding to investigate and report offences and other misconduct to ASIC, including phoenix activity. A particular focus of ASIC's Assetless Administration funding provided to liquidators is to report on phoenix activity: see ASIC Regulatory Guide 109.4.

Our members regularly do so. ASIC's 2010-2011 annual report (p 82) says that its AA funding allocation of $3.4 million for 2010–11 was fully applied and that "funded liquidator reports assisted in approximately 70% of director bannings in 2010–11".

ATO view

We can understand that the ATO in effect wants to provide a recovery process alongside the insolvency process and seek to attack phoenix activity by way of focusing on the directors. The 21 day period given under a DPN during which directors can take action to avoid personal liability is seen by some as a reward, in effect giving directors the warning to liquidate, which the ATO feels is being abused by phoenix operators. Our earlier point though is that many companies owe tax when they go into liquidation or administration, often after a DPN is served, but not all such companies are phoenix operations by any means. Those directors may well be acting properly, even if prompted by the ATO, in putting their insolvent company into liquidation or administration. A director is acting properly if they put their insolvent company into insolvency, whatever the nature of its liabilities. As an incentive or inducement, those directors have the 'reward' of protection from personal liability. This should be encouraged as putting the company into formal insolvency serves to mitigate further losses to all creditors. We do not disagree with the fact that fact that the ATO has these powers. They have existed for close to 20 years and are an integral part of the insolvency regime. However the IPA considers they should be used on a more timely basis. See IPA submission 15 January 2010.

The DPN system depends on the ATO serving penalty notices, giving directors 21 days to take action. A DPN is therefore a useful means by which directors of insolvent companies are prompted to properly dealt with by the insolvency laws. Our members report that the service of a DPN will often result in a director seeking urgent insolvency advice. Other pressures, including insolvent trading liability, have often not been strong enough to cause a director to act.

Misuse of employees' money

We support any regime whereby an insolvent company is placed into a formal insolvency administration. The policy approach has been to impose a potential liability for employee withholding taxes on directors to achieve this.

Our members see similar problems in superannuation moneys not being paid by employers, instead using that money for the benefit of the company, or the directors' own benefit. We therefore support an extension of the penalty notice regime to superannuation payments. These are also not the company's money.

Misuse of such moneys involves the company, through its directors, properly withholding PAYG tax from an employees' wage and superannuation contributions, and then improperly not remitting that money as required. Rather the money is used for the company's own purposes. It is perhaps not a matter of an 'innocent' director – directors have their defences if they want to show they were not responsible for the misuse of the moneys.

Our members report that in the many insolvency matters there is significant misuse, with unpaid superannuation contributions often not having been paid for many years. In addition to the arguments we have outlined above, by failing to remit withholding taxes and employees' superannuation, these companies have an unfair advantage and are using funds to which they are not entitled. There is also a social impact on those affected through non-payment of superannuation as those employees ultimately have less funds available to them upon retirement which in turn puts more strain on government funding for retired persons.

The law and the courts see this misuse as serious misconduct. In *Cullen v Corporate Affairs Commission* (1989) 7 ACLC 121, 127, pre-dating these laws, the court said that what was then group tax "is part of the employees' wages which have been withheld to be paid to the tax office on behalf of the employees. They are, for all intents and purposes, trust moneys which do not belong to the company. If the company's directors use these moneys for trading purposes, it shows a complete lack of appreciation of this situation and a serious lack of commercial reality."; also see *Didovich v ASIC* [1998] NSWSC 534.

In the same way that PAYG tax and employee superannuation are not funds to which the company is entitled, we consider that GST is the same. We suggest consideration be given to including unremitted GST to the obligations that give rise to a DPN being issued. We note GST is not considered in the proposed legislation.

Defences

The draft legislation provides where the tax/SGC debt is unreported for 3 months, the ATO will not have to issue a DPN as the directors will be automatically liable. There is no indication this provision would only apply to directors of phoenix companies. Therefore there has been concern expressed about allowing what are referred to as 'honest' directors proper defences to an ATO claim. We share that concern in particular if it means that what we consider is the strong impact of a director being served with a DPN giving 21 days to act. It generally causes the recalcitrant director to act; and it also maintains some fairness in the DPN process. A DPN as a warning notice would give more focus on ensuring that honest directors were not caught and give some second chance to 'first time directors' in this situation.

The defences to a tax penalty notice are generally the same as those presently available for insolvent trading - s 588H, and for directors indemnity of the ATO - s 588FGB. That is, it is a defence if:

- illness or other good reason meant it would have been unreasonable to expect the director to take part in the management of the company; or

- if the director took all reasonable steps to ensure that the company complied; or

- if the director caused an administrator of the company to be appointed, or the company wound up;

- in all cases, taking into account when, and for how long, the person was a director, and all other relevant circumstances. There is extensive case law on these defences and how they apply.

An 'honest' director - however that may be defined – should be able to find a defence in these provisions. But as we say, we think it is preferable that the director still be put on notice up-front, by a DPN, that unless they take proper action as the law requires, personal liability will be imposed on them.

IPA suggestion

We also make this as an alternative or supplementary suggestion. A liquidator is required to report to ASIC under s 533 of the *Corporations Act* if (among other issues) a company may be unable to pay its unsecured creditors more than 50 cents in the dollar. If such a section 533 report has previously been lodged with ASIC in the liquidation of another company of which that the person was a director, then the DPN law may apply without notice being provided. If the person has not previously been the director of a company in this situation, then a penalty notice served according to the existing system is required for personal liability to apply.

There is some precedent for this sort of defence under s 206D of the *Corporations Act*, whereby a director of an insolvent company can be disqualified as a director by ASIC but only if they have been responsible for two or more insolvent companies.

ASIC and ATO

This would require the ATO and ASIC to communicate effectively. 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. According to its Explanatory Memorandum, the ATO may provide information to ASIC in order to allow ASIC to identify and penalise breaches of corporate law. "Information held by the ATO may be invaluable for ASIC in pursuing action against directors who may repeatedly be engaged in fraudulent phoenix activity".

We see no reference to this law in the Explanatory Memorandum to these Bills. As we have said, our member liquidators refer many breaches of law and other misconduct to ASIC, including phoenix activity. We would like to assume that there are now communications under this new law between ATO and ASIC in relation to Phoenix activity and that these are having an impact.

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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