# Submission

## Commercial Law Section

To: The House of Representatives
Standing Committee on Legal and Constitutional Affairs

## Submission on Bankruptcy Legislation Amendment (Anti-Avoidance and other Measures) Bill 2004

A submission from the Insolvency and Reconstruction Committee

Date: 23 June 2004

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## Key to Terms Used

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| **ATO** | Australian Taxation Office |
| **Bankruptcy Act** | Bankruptcy Act 1966 |
| **BLAAAM** | Exposure Draft of the Bankruptcy Legislation Amendment (Anti Avoidance and other Measures) Bill 2004 |
| **Consultative** | Bankruptcy Legislation Reform Consultative Forum |

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| **Forum** | convened by the Inspector General in Bankruptcy |
| **Explanatory Memorandum** | Exposure Draft of the Explanatory Memorandum to the Bankruptcy Legislation Amendment (Anti Avoidance and other Measures) Bill 2004 |
| **Family Law Act** | Family Law Act 1975 |
| **FLS** | Family Law Section of the Law Institute of Victoria |
| **IRC** | Insolvency and Reconstruction Committee of the Business Law Section of the Law Institute of Victoria |
| **ITSA** | Insolvency and Trustee Service Australia |
| **Joint Taskforce** | Joint Taskforce of the Attorney General's Department, Australian Tax Office, Insolvency and Trustee Service Australia and Treasury in relation to the use of bankruptcy and family law schemes to avoid payment of tax January 2002 |
| **Taskforce Report** | Report of the Joint Taskforce of the Attorney General's Department, Australian Tax Office, Insolvency and Trustee Service Australia and Treasury in relation to the use of bankruptcy and family law schemes to avoid payment of tax; January 2002 |
| **LIV** | Law Institute of Victoria |

## EXECUTIVE SUMMARY

The BLAAAM is the product of an ATO driven initiative which arose out of a perception that a small number of high income professionals were utilising the provisions of the Bankruptcy Act as a means to avoid paying tax, while still retaining the fruits of their labours within the family unit.

The LIV submits:

- from a policy perspective the case for change has not been established;

- the proposed solution to what is a perceived problem, as contained in Schedule 1 to the BLAAAM, is draconian in the manner in which it permits the appropriation of the interests of innocent third parties in property;
- if enacted, Schedule 1 is likely to be largely unworkable due to its failure to meet basic requirements of statutory drafting, namely the inclusion of undefined and subjective terminology and the inclusion of phrases having no meaning in a bankruptcy context;
- there is a real issue as to the constitutional validity of integral parts of Schedule 1;
- there has been no explanation for the failure of ATO systems in the past which permitted abuses to go undetected;
- with recent initiatives of the ATO in relation to auditing what the ATO considers "high risk" industries likely to minimise (and at best eliminate) future abuses there is no need for such wide sweeping change ;
- there are real alternatives that can properly address the concerns of the ATO within the current framework of the Bankruptcy Act and without transgressing upon third party property rights;
- while the high income professional is the stated target of these proposals it is the families of the innocent business and non business bankrupts alike who have most to fear from these provisions, which will seek to undo transactions society has always deemed appropriate and acceptable in the organisation of a family's affairs; and
- with the proposals being the subject of consideration by the ATO since at least March 2001 the sudden urgency the Government attaches to these proposals, and the failure to allow adequate time (one month) for public debate on the exposure draft, is oppressive.

The LIV invites the Government to form a commission of inquiry to examine the policy and operation of the Bankruptcy Act as a whole. Any derogation of the rights of creditors in favour of the non bankrupt spouse should only be considered as part of such overall review to ensure a proper balance is achieved to what are otherwise irreconcilable policy positions.

## INTRODUCTION

The LIV welcomes the opportunity to provide this submission in response to the invitation of the Attorney-General, the Honourable Phillip Ruddock, and the House of Representatives Standing Committee on Legal and Constitutional Affairs[1] to comment upon the BLAAAM.

The submission has been prepared by the Insolvency and Reconstruction Committee of the LIV. It is to be noted that the FLS adopts a contrary policy objective to that of the IRC in relation to a number of matters in Schedule 2 to the BLAAAM. Where it is known that there is divergence of opinion in this regard it has been noted.

The submission includes a review of the following matters:

- the process of consultation undertaken by the Government leading up to the presentation of the BLAAM;
- a review of the Government's policy behind the BLAAAM;
- a critique of the operation of the respective parts of the BLAAAM; and
- a recommendation as to how the Bankruptcy Act may be amended to counter the perceived failings in the Bankruptcy Act without attacking the property interests of innocent third parties.

Should the Committee require clarification of any of the matters contained in this submission the LIV would be happy to provide such assistance as it can. In this regard any inquiries, in the first instance, should be directed to the LIV's representative on the Consultative Forum whose contact details are as specified below:

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**THE LAW INSTITUTE OF VICTORIA AS REPRESENTATIVE OF THE LEGAL PROFESSION**

It is recognised that "high income professionals" are a stated target of the ATO and the Government in introducing the BLAAAM[2] and that the legal profession, generally, is one of those professions identified in the Taskforce Report as being of particular concern to the ATO.[3]

The LIV, as a representative body for the legal profession in Victoria, realises that, in opposing the BLAAAM, it may be criticised for merely acting in its members vested interests.

However, it is a misconception to state that these provisions will only operate, and have effect, with respect to high-income professionals. The majority of business bankruptcies in Australia are not high-income professionals but are business persons who, for one reason or another, have failed in their business enterprise[4]. It will be the small business operators such as farmers, truck drivers and shop owners who go bankrupt who will be most affected by these changes. The Government decision to present this as a bill to protect creditors from the scheming of high-income professionals is misleading and wrong.

The LIV does not condone the conduct of individuals who fail to comply with their taxation and other legal obligations. The LIV supports the prosecution of those individuals who flout the laws of the Commonwealth. In the case of the legal profession it may be appropriate for certain cases of abuses of the law to be referred to the relevant professional body for the purpose of requiring the individual to show cause why their right to practice ought not be revoked.

## THE PROCESS OF CONSULTATION

### SUMMARY

- The reforms the subject of the BLAAAM are the product of an ATO driven initiative. The reform proposals have been presented as part of the Government's policy agenda for bankruptcy reform.
- Whether the Government's policy agenda might be realised in some different manner has not been explored by any independent commission of inquiry or the subject of public debate. This is despite the recommendation of the Joint Taskforce that proposals in relation to Recommendation 3 be the subject of consultation with stakeholders.
- Notwithstanding there has been a process of consultation of over one year the Government has provided just over one month for public comment on the exposure draft itself. With the BLAAAM including significant divergence from earlier recommendations, and the full scope of proposals only now being made public, the opportunity afforded public comment is unrealistic.

**CHRONOLOGY**

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| 22 March 2001 | The Attorney-General and Assistant Treasurer announce an inter-agency Taskforce made up of representatives from the Attorney-General's department, ITSA, Treasury and the ATO. |
| January 2002 | Joint Taskforce Report titled *The Use of Bankruptcy and Family Law Schemes to Avoid Payment of Tax* issued but **not** released to public.<br><br>Recommendation 3 relevantly provided that a committee be formed... "to review the law relating to "looking through" asset ownership structures under the Bankruptcy Act...**in consultation with relevant stakeholders.**" |
| 20 February 2003 | ITSA releases a "Discussion paper" detailing "some suggested changes" resulting from the Taskforce Report and inviting comment. |
| July 2003 | ITSA releases edited version of Taskforce Report. |
| 15 July 2003 | ITSA releases paper for consideration by the Consultative Forum meeting for 29 July 2003. In relation to Recommendation 3, it was noted that "The Committee ... has commenced its review..." of the relevant law. Stakeholders have not, and were not asked to, participate in that review. |
| 29 July 2003 | Consultative Forum Meeting at which a large number of concerns raised by stakeholders in relation to Recommendation 3. |
| 17 October 2003 | ITSA releases amended paper for consideration by the Consultative Forum addressing a key concern raised at the meeting of 29 July 2003. In particular it notes that the review by the Committee is complete and that it now proposes "...that the revised recommendation [3] should only apply to the spouse or defacto of the bankrupt and not to associated entities." |

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| 11 November 2003 | Meeting of Consultative Forum but no further debate of Taskforce Report; only a status report was provided. The Law Council representatives again noted opposition to Recommendation 3. |
| 16 December 2003 | Government announces proposed changes to Bankruptcy Act to adopt Taskforce Recommendation. |
| 19 December 2003 | Meeting of Consultative Forum but participants advised that policy is now set in stone and no further debate to be entered in that regard. |
| 4 February 2004 | Meeting of Drafting Workshop attended by Consultative Forum representatives. Draft Bill presented for discussion purposes and largely criticised by non-government representatives. Law Council forms view that draft Bill is oppressive and technically unworkable in present state. |
| 9 March 2004 | Consultative Forum meeting where possible changes to draft bill raised. ATO representative opposed any restriction on the scope of the proposals. |
| 14 May 2004 | Attorney-General releases BLAAAM and announces referral to House of Representatives Legal & Constitutional Committee |
| 18 June 2004 | Due date for public submissions on BLAAAM |

Since 1966 bankruptcy law reform has largely been a process of Government reaction to a public perception of weaknesses in the system. Most recently, in 1992, there were the "Skase" amendments. This was followed by the so-called modernisation of the antecedent transaction provisions in 1996, a myriad of amendments in 2002 and, most recently, the review of Part X of the Act. The BLAAAM is the latest instalment in this process.

The Harmer Report[5] contained a review of the operations of the Bankruptcy Act and corporate insolvency law. A number of its key recommendations were enacted in relation to corporations, however its recommendations in relation to bankruptcy were acted upon to a lesser extent.[6]

The Government has announced further amendments to rectify the weaknesses disclosed by the High Court decision in *Cook v Benson*[7] and in recent years have made a number of additional isolated changes, including non release of HECS debts upon discharge from bankruptcy and priority granted to proceeds of crime applications over the interest of creditors.

The LIV has long recommended an overall review of the Bankruptcy Act particularly with regard to the operation of Section 116(2), which excludes specific items of property from being available to creditors. It is submitted that the present conflict between family law and bankruptcy can only be reconciled through a policy decision as to what property is to be exempt from being available to creditors and any such exemption should properly take place through an overhaul of Section 116.

In particular there are a number of examples of an individual's investment choices being influenced by whether or not such investment will be available to creditors upon bankruptcy. For example:

- If a debtor has $5000 in a bank account upon bankruptcy that money will be available to creditors. However if the day before bankruptcy the debtor spends that money on household furniture and effects or a second hand car neither the fund of money nor the property purchased with it will be available to creditors.
- If a debtor has $100,000 in a regulated superannuation fund that money is not available to creditors. However if a self employed person who chooses to invest $100,000 in reducing the mortgage on his or her business or family home rather than invest it in superannuation the benefit of the equity in those assets will be available to creditors.

Any decision to further exempt a bankrupt's assets from being available to creditors should be undertaken after a review of the overall operation of the Bankruptcy Act. To do otherwise may result in a lack of consistency in policy and application of bankruptcy laws.

In addition, rather than increasing the ever expanding divergence between corporate and personal insolvency laws, a review should be undertaken to determine to what extent those laws can be unified. Why there is a need for two entirely different processes for convening of meetings in the respective jurisdictions is an ongoing concern.

Finally, as noted above, the Government is presently reviewing its response to the High Court decision in *Cook v Benson*. It is likely that response will impact upon the current proposals for amendment and it is unfortunate that it cannot be dealt with in conjunction with, or as a part of, BLAAAM.

## POLICY CONSIDERATIONS FOR INSOLVENCY REGULATION

### SUMMARY

- Any policy discussion should be assessed against the fundamental principles of Australian bankruptcy and insolvency laws.

- The BLAAAM constitutes a significant departure from commonly regarded fundamental principles of our bankruptcy and insolvency law. This does not appear to have been considered by the Joint Taskforce.

**GENERALLY**

In 2000, the Productivity Commission released a Staff Research Paper entitled *Business Failure and Change: An Australian Perspective.*[8]. That paper outlines (at pp 76-77) three reasons "why insolvency policy matters more than might be obvious at first glance".

*"First, regulatory provisions for business insolvency have effects beyond those just related to the failing business — they affect economic incentives more broadly by changing the willingness of people to lend money to businesses, and the level of prudence adopted by entrepreneurs. This affects every business in the economy. ...*

*Second, the costs associated with individual business failures for creditors can be relatively high and sometimes concentrated on vulnerable groups (such as employees).*

*Third, insolvency regulation can partly determine the extent of reorganisation of resources in an economy over time, with potential long run impacts on overall business dynamism and productivity."*
Likewise in his review of insolvency in an international setting, Wood[9] has stated (at p 1):

*Insolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go around and so the law must choose whom to pay. The choice cannot be avoided or compromised or fudged. The law must always decide who is to bear the risk so that there is always a winner and a loser. On bankruptcy it is difficult to split the difference. That is why bankruptcy is the most crucial indicator of the attitudes of a legal system and arguably the most important of all legal disciplines.*

This underlines that an approach to the vexed question of the interaction of bankruptcy law and family law should achieve a balance of policies, recognising not only the social implications of family breakdown, but also the very real economic implications of bankruptcy regulation.[10]

In 2003, the Commercial Law League of America submitted to the Supreme Court of the United States an "amicus brief" in support of the Sixth Circuit's decision in *Hood v. Tennessee Student Assistance Corp.*, 319 F.3d 755 (6 th Cir. 2003). (The Sixth Circuit had rejected the State's assertion of sovereign immunity as a defence to a debtor's complaint to have a student loan discharged). The full text of the brief is at:

http://www.cllabankruptcy.org/bankruptcy/TNStud.v.Hood-AmBrofCommercialLaw.pdf .

The fundamental concept espoused in that brief is a timely reminder of the historical basis for inclusion in the Constitution of a "bankruptcy and insolvency" head of power:

> The thought which we will develop is that when insolvency comes the debtor's affairs should be liquidated for the benefit of his creditors on the basis of equality. As a corollary, the debtor (if he aids toward that end) ought to be discharged from further liability on the debts to which, on a basis of equality, he has now dedicated his assets. *Garrard Glenn, The Law Governing Liquidation (Baker Voorhis & Company 1935)* at 4.
> The "reality" is "that debtors and creditors are partners in debt, and never more so than when debtors are insolvent." *Bruce H. Mann, Republic of Debtors: Bankruptcy in the Age of American Independence, 45 (Harvard U. Press 2002).*
> "[T]hose who are interested in the American system must give English origins the place of first importance." Glenn at 291. At the start of the Eighteenth Century, English law first recognized what common sense and practical experience taught: **creditors recover more assets, faster and with less cost, when the motivation for debtors to deliver their assets for distribution to creditors arises not only from compulsion but also from reward.** [Emphasis added]

**POLICIES UNDERPINNING INSOLVENCY REGULATION**

In 1988, the Australian Law Reform Commission in its *General Insolvency Inquiry* [11] outlined the broad policies that should underpin insolvency regulation. These are outlined below, together with particular commentary relevant to the interaction of bankruptcy law and family law:

1. The fundamental purpose of an insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvency individuals and companies.
   Bankruptcy is a collective administration. The trustee must consider not only the creditors pressing for payment but all creditors (voluntary and involuntary) and other third parties who may be affected (such as landlords). To what extent should this include the family members, over and above provisions on exempt property and retained income?

2. Insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense.

3. An insolvency administration should be impartial, efficient and expeditious.

Bankruptcy requires efficient administration procedures. It is a given that there is not enough money to go around. This would support as simple a solution as possible to avoid procedures that unnecessarily waste time and money on disputes.

4. The law should provide a convenient means of collecting or recovering property that should be applied toward payment of the debts and liabilities of the insolvent person.

This is relevant to convenient and efficient recovery of property from associated entities.

5. The principle of equal sharing between creditors should be retained and in some areas reinforced.

*Pari passu* distribution almost seems to be more honoured in the breach but should not be overlooked as the starting point. The New Zealand law reform body's approach on priority creditors was to write to parties with priorities and ask them to justify why the priority should be retained.[12]

6. The end result of an insolvency administration, particularly as it affects individuals should, with very limited exceptions, be the effective release from the financial liabilities and obligations of the insolvent.

A feature of bankruptcy law within the common law tradition has been the notion of rehabilitation of an honest, yet unfortunate, debtor. To achieve this, an individual debtor upon termination of his or her bankruptcy is discharged from liability for provable debts.

Given the impact of a person's insolvency on their family, should there be any sense that the "rehabilitation" should extend to the bankrupt's spouse / dependants. Should the "family" participate in the fresh start and to what extent would it be with or without "family" assets?

7. Insolvency law should, so far as convenient and practical, support the commercial and economic processes of the community.

Lack of confidence in the provision of credit may have wide-ranging ramifications for the market economy. Commerce requires certainty and predictability in regulation. Financial benefits for families may well be lacking if the pendulum swings too far in the favour of property being available for family members to the detriment of commercial dealings.

8. As far as practicable, insolvency law should harmonise with the general law.

Sometimes there are clashes between areas of law. For example, an otherwise valid security may be invalid under the voidable transaction provisions. Thus it may be appropriate that family law principles yield to bankruptcy principles in certain circumstances.

**ASSESSMENT**

- The LIV is critical of the drafting of the proposed Division 4A of Part VI in BLAAAM. In the event BLAAAM becomes law the present drafting is likely to undermine the legislature's objectives if the Courts struggle to apply the provisions in a meaningful and consistent manner. This is likely to result in;
    - significant cost being incurred by trustees and respondents alike in bringing and defending actions under the new Div 4A of Part VI due to lack of certainty as to how those provisions are to be applied; and
    - lack of certainty of outcome for the same reasons stated above.
- Division 4A creates a complex mechanism that is ultimately unstructured as to the form of outcome to be sought by a trustee.
- Division 4A does not provide convenient and practical support for the commercial and economic processes of the community. Rather it seeks to undo well established principles of property ownership which may give rise to significant (and to date unconsidered) commercial and tax consequences for those having to undo or give up legitimate proprietary rights.
- BLAAAM does not harmonise with the common law and equitable rights in property. It abrogates interests that have for centuries been recognised at law and equity and are the cornerstone of our property laws.
- Schedule 2 to BLAAAM undermines the principles of *pari passu* distribution in that a non-bankrupt spouse can apply to the Family Court for a property or maintenance adjustment out of the bankrupt's property otherwise available to creditors.
- In recent years the Government has shown a greater propensity to ignore established principles of insolvency and property law to advance the interests of the ATO and revenue to the detriment of creditors generally. For example, there have been amendments to provide that liability for accumulated HECS debt is not released upon bankruptcy.[13] Similarly the Bankruptcy Act was recently amended to grant priority to the Crown over forfeited property, the subject of a Proceeds of Crime order, to the detriment of creditors.[14] Such provisions undermine the principle of *pari passu* distribution and equity amongst creditors and yet neither was the subject of any consultation with the Consultative Forum.

## THE POLICY DEBATE ON THE NEW DIV. 4A

### SUMMARY

- It is submitted the Taskforce Report, from which the BLAAAM derives[15] is an inappropriate document upon which to base such radical reform. The Report is largely the product of a single government creditor[16] which, whether or not addressing its own apparent shortcomings in its debt recovery and enforcement procedures, has sought to blame any revenue shortfall upon perceived shortcomings in the scope and application of the Bankruptcy Act.

- Division 4A of Part VI goes well beyond the Joint Taskforce Recommendation as advised on 17 October 2003.

- While seeking to stop perceived abuses of bankruptcy and family law by high-income professionals by the introduction of Div.4A of Part VI, the proposals in Schedule 2 may undermine these provisions by facilitating applications by non bankrupt spouses to the Family Court for declarations in relation to the bankrupt's property.

### A RECENT CASE STUDY: *PRENTICE V CUMMINS*[17]

This case concerned a bankrupt who had been a Queens Counsel since 1980, deriving significant remuneration. It was an admitted fact that the bankrupt had not filed an income tax return since 1955, a period of 45 years.

Not surprisingly the single biggest creditor was the ATO. While deploring the apparent criminality involved on the part of the barrister, one still wonders why there appears to have been, in all those years, no cross-checking of the Law Society listing of QC's against the ATO's listing of current taxpayers.

The trustee in bankruptcy successfully prosecuted a recovery action against the Bankrupt's wife relating to a disposition by the bankrupt of all of his interest in the family home and other assets in 1987, 13 years prior to his bankruptcy.

It is understood the ATO finally caught up with the bankrupt as a result of an audit program targeting the legal profession.

What can be learnt from this case is that;
- the ATO already has sufficient power to identify criminally deficient behaviour such as that undertaken by the bankrupt; and
- the Bankruptcy Act in its present from does operate to protect creditors in circumstances such as the ATO found itself in.

### ASSET PLANNING NOT ASSET PROTECTION

Under Australian Law, the measure of an individual's wealth is the value of the property owned by that person. In what is a fundamental misconception in the Explanatory Memorandum, the Joint Taskforce report and in the Attorney General's speech to the ITSA Fifth National Bankruptcy Congress,[18] each either expressly states, or otherwise implies, that an individual's "true wealth" includes property owned by third parties. Such expressions bear no relation to the laws of Australia and are a product of tabloid journalism.[19]

The language adopted in the Taskforce report, the Explanatory Memorandum and the BLAAAM, such as "tainted property," "tainted money" and "anti avoidance measures" seeks to imply that the structuring of an individual's affairs in a certain manner is inherently wrong or illegal. This is not, and has never been, the case under the laws of Australia. Even our taxation laws have long recognised the right of the individual to structure one's affairs within the compass of our laws.[20]

It is contended in the Explanatory Memorandum, the Taskforce report and the Attorney General's speech of 14 May 2004 that it is unjust to the interests of creditors to allow a bankrupt's family to retain the benefits of the bankrupt's life time labours to the exclusion of those creditors. With respect, this is a simplistic approach that, while attractive to the popular press, fails to address the question at hand.

Rather, the LIV submits that the question should be reframed as follows:

*What right does a creditor have to alienate the proprietary rights of innocent third parties who have accrued such rights from the bankrupt?*

The answer to this question is obvious, when viewed within the framework of Australian bankruptcy law. Namely, a creditor should be entitled to avoid any transaction undertaken by the bankrupt with the intention of defeating that creditor's interests. The law has always recognised that in such circumstances a mere volunteer will not be entitled to retain such proprietary rights as against the creditors. The question as presently framed by the legislature fails to recognise the legitimacy of such accrued rights.

While the BLAAAM creates a protective mechanism for separating spouses, nowhere has there been provision for the interests of the spouse that stays with his or her bankrupt partner. Instead, the Bankruptcy Act creates specific presumptions against such innocent third parties, bestowing upon them the onus of asserting and proving the existence of proprietary interests which the law has long recognised. This discrimination against married couples is unfounded and unwarranted. In families suffering the stress of a bankruptcy the Government should not be surprised if these provisions, if enacted, constitute the final blow for what might already be a fragile relationship. This is particularly so where, upon separation under the new regime, the bankrupt spouse will be entitled to go to the Family Court to seek an adjustment of proprietary rights with respect to property of the bankrupt otherwise available to creditors.

It has also been contended in support of the Government's proposal that it is always open for an individual to insure against risk. This is not the case. The current market for insurance is in upheaval and for individuals who, by virtue of their professional standing, are unable to incorporate are unfairly prejudiced *vis a vis* those businesses which are able to operate through corporate entities. The medical profession is continuing its debate with the Government in relation to appropriate insurance levels. There is also an attempt to enact uniform laws capping liabilities of certain professionals. This endorses the position that in many instances insurance is not an appropriate answer (or indeed available in many instances) to addressing the risks of business. Recent history shows that even if parties can obtain insurance in a greatly reduced market there is a real risk of insurer default[21] and a practice of insurers denying liability in cases where there is an allegation of fraud (such be an exclusion in many cases) until such claim is disproved. If liability is denied it will be small solace to the insured if, in the meantime, they are forced into bankruptcy due to inability to fund the costs of defending a claim.

No justification has been given for the discrimination against individuals who are otherwise unable to incorporate. From a competition policy perspective there would appear to be a financial advantage to those who can minimise risk through incorporation. It was for this purpose that the corporation developed.

Finally, in its discussion paper of 17 October 2003 the Joint Taskforce recommended that the provisions only relate to spouses and defacto spouses of the bankrupt. Clearly that has not been followed.

**DO "HIGH INCOME PROFESSIONALS" USE BANKRUPTCY TO AVOID PAYMENT OF TAX?[22]**

The Taskforce Report makes reference to a report from the Australian National Audit Office that refers to ATO studies that disclosed that "a relatively small number of high income debtors (with substantial tax debts) use bankruptcy as a means of avoiding payment of their tax".[23]
The Taskforce Report goes on to note that the ATO had identified 62 barristers in NSW who had been subject to an administration under the Bankruptcy Act over a 10 year period of which, in 56 cases, the ATO was sole creditor for a tax debt of just over $20 million.
In identifying 8 groups of professionals ITSA concluded that between 1996-2001 the number of bankruptcies in Australia falling within those groups, and the ATO total debt was as follows[24]:

| Year | No. of Bankruptcies | ATO Debt |
|---|---|---|
| 2001 | 17 | $2.5m |
| 2000 | 37 | $8.8m |

| | | |
|---|---|---|
| 1999 | 27 | $3.9m |
| 1998 | 39 | $3.5m |
| 1997 | 43 | $3.8m |
| 1996 | 21 | $0.9m |

The publication of ITSA *Profiles of Debtors 2003* states that for the calendar year 2003 there were 21,900 bankruptcies of which 5.23% disclosed their occupation as being professional[25]. This compared with the 2001 Government census figures of 18.2% of persons disclosing their occupation as professional[26]. It is difficult to reconcile this percentage figure with the above table.

The Taskforce Report, in describing these matters, uses language such as;

- "a pattern of behaviour"[27]; and
- a "problem of high wealth individuals using bankruptcy to avoid their taxation obligations".[28]

Such expressions are difficult to support on the facts as presented.

It is submitted that on the data referred to in the Taskforce Report there is insufficient evidence to conclude that there is endemic avoidance of tax by high income professionals by going bankrupt.

**ARE HIGH INCOME PROFESSIONALS CAUSING A "BLACK HOLE" IN ATO REVENUE THROUGH BANKRUPTCY?**

Of the above mentioned bankruptcies the ATO appeared as a creditor in 18% of all administrations representing 10% of total debts compared with banks and financial institutions appearing in 70% of all administrations and representing 44% of all debt.[29]

It is submitted that the loss of tax revenue, as a percentage of all claims provable in a bankruptcy does not warrant the wholesale changes being proposed. Any perceived issue is not one so much for the ATO but one for creditors generally[30]. Yet within the Consultative Forum the Australian Banker's Association has expressed concern as to the scope of the amendments[31]. The only active supporter of the amendments throughout the "consultation" process has been the ATO.

The reforms are not being introduced because of any widespread community concern but because of the concerns of a minority stakeholder. Government should exercise caution in enacting legislation the product of lobbying by a minority stakeholder so as to ensure the wider community interests are being

protected[32]. The Government might seek to adopt a paternalistic response to such a suggestion, on the basis that it "knows what is best". With respect, that argument is not made out in the Taskforce Report and might be challenged upon ideological grounds.

**IS THE ATO A "DISADVANTAGED" CREDITOR REQUIRING SPECIAL CONSIDERATION?**

In the Executive Summary to the Joint Taskforce report the ATO contends that it is at a disadvantage to other creditors. It states that the ATO does not have the benefit of being of the "general run of commercial credit providers" who are able to assess whether or not they are to provide credit. Rather, it is merely a collection agent for the Commonwealth, of a liability imposed by statute. The ATO, it is stated, cannot (unlike commercial creditors) withdraw these services.

Notwithstanding these obvious comments, to suggest that the ATO is in a disadvantaged position borders disbelief. In particular:

- the vast majority of taxpayers have their income tax deducted by their employer;
- for those who are self employed, the ATO has vast information resources unparalleled to that of any other creditor; and
- the ATO has unparalleled powers of enforcement including easing of evidential burdens, garnishee powers etc.

The ATO's practice in recent years of targeting specific professions has shown that it does have the resources to detect and monitor miscreant taxpayers. One would hope that the example of the Cummins bankruptcy is a thing of the past. Having detected a failure to comply with the taxation laws, the ATO has unparalleled powers in relation to obtaining judgements and garnishing wages. These powers are not open or available to the ordinary commercial creditor.

In 1993, the Government determined that the position of the ATO in corporate insolvency administrations was to be no different to any other creditor. For the Government to now seek to enact draconian legislation on the premise that the ATO is being unfairly prejudiced by the activities of some individuals is to reverse that policy.

No consideration of these matters appears to have been undertaken in the Taskforce Report.

A further consideration of relevance is that the ATO has the financial resources not available to the usual commercial creditor in a bankruptcy to fund recovery actions for the benefit of creditors. The Taskforce Report recognises this as an issue to be addressed. However, there is strong anecdotal evidence that the ATO is reluctant to fund insolvency practitioners to run meritorious

cases for the recovery of property in other than cases having public notoriety. In a similar vein when the GEERS scheme was originally established, it was envisaged that the Government would, in its position as a priority creditor in insolvency administrations, utilise some of GEERS resources in funding recovery actions by insolvency practitioners. The LIV is not aware of any instance of the GEERS scheme funding a recovery action by an insolvency practitioner.

It is suggested that the ATO needs to review its internal processes so as to encourage ATO officers to work with insolvency practitioners in identifying and appropriately funding meritorious recovery actions.

## DOES THE BANKRUPTCY ACT CURRENTLY FAIL CREDITORS?

### SUMMARY

- The LIV is of the opinion that the present antecedent transaction provisions contained in Sections 120 and 121 of the Bankruptcy Act are generally appropriate for recovery of property for the benefit of creditors. They properly reflect laws with respect to bankruptcy in that the ability to avoid a transfer of property is premised upon the insolvency of the debtor at the relevant time.

- There are a number of potential options for fine tuning the existing provisions considered further below which could be undertaken to better assist trustees in recovering antecedent transactions for the benefit of creditors.

### RECOVERING ANTECEDENT TRANSACTIONS

The origins of today's "claw back" provisions are found in the Statute of Elizabeth of 1570[33] which declared void dispositions made with the intention of defrauding creditors[34]. Such provisions are the mechanism by which a fundamental principle of our bankruptcy laws, namely that the property of the bankrupt is to be rateably distributed amongst creditors[35], may be enforced. Dispositions of property by a bankrupt prior to the commencement of his or her bankruptcy may be recovered for the benefit of creditors as a whole if made for less than market value consideration[36], or with the intention of defrauding creditors[37] or which had the effect of preferring one creditor over another[38]. The Federal Court of Australia and the Federal Magistrates Court have jurisdiction to set aside transactions that fall within the ambit of these provisions[39].

### PROBLEMS

The Taskforce Report does not identify any existing failings with the current sections 120, 121 and 122 of the Bankruptcy Act. Rather the Joint Taskforce

laments that such property it would like to recover was never owned by the bankrupt.

However there are a number of concerns as to the operation of sections 120 and 121 which have been identified. In particular:

- Where the house property is registered in the sole name of the non-bankrupt spouse, yet was always intended to be the family home for the joint benefit of the spouses, a trustee in bankruptcy will have difficulty proving the existence of a "common intention" constructive trust in favour of the bankrupt in circumstances where the husband and wife each lead evidence that no such common intention existed.

- The decision of the High Court in *Cook v Benson*[40] might one day create problems for trustees who seek to set aside transactions whereby the bankrupt transfers assets to a "fund manager" on a trust in identical form to that trust deed in *Cook v Benson* save that it is not called or registered as a superannuation fund. The decision of the High Court would suggest the "fund manager" gives good consideration for the transfer to it. The reasons for judgment of Kirby J repay study as, even though His Honour constituted the minority, he helpfully explains the "beneficial" nature of the existing claw-back provisions.

- No trustee has yet tested the case of a bankrupt who had paid the mortgage over the property registered in the name of the spouse. While those payments may be recoverable, to what extent can a trustee claim a greater equitable entitlement arising from any capital appreciation over the relevant period?

## PROPOSED DIV. 4A OF PART VI

### SUMMARY

- The provisions are badly drafted in that several key matters of proof for a trustee concern non-defined, subjective terms without indication as to how they are to be interpreted. This may result in a serious undermining of the Government's stated objective where Courts err in favour of maintaining existing proprietary rights.

- The requirement of having to prove a "tainted purpose" in most cases will likely mean the application of these provisions, beyond what section 121 now covers, will be very limited.

- Section 139AL permits double dipping by trustees who may seek to assess the bankrupt for contributions while claiming the product of the labours.

- Section 139AFA is misconceived in directing the inquiry to the wrong subject matter in some instances.

- If the provisions are capable of application as intended, (which is doubted) the provisions will have a number of unintended consequences bordering upon the draconian.

**OVERVIEW OF OPERATION OF SCHEDULE 1**

To attract the jurisdiction of the Court under Div. 4A the trustee in bankruptcy must first establish that a respondent owns "tainted property" or "tainted money".

| Action | Particulars | Section |
|---|---|---|
| Trustee may apply to Court for order under Division | • application within 6 years of date of bankruptcy | 139A |
| If Court is satisfied that Respondent owns<br>1. "Tainted Property"; or<br>2. "Tainted Money";<br>Court may make a vesting or payment order | | 139D<br>139E |
| In determining whether to make and order Court **must** take into account the prescribed criteria and no other matters | Property vesting order<br>Money payment order | 139F(1)<br>139F(2) |
| Respondent can prove in Bankruptcy for dividend | | 139H |

"Tainted Property" and "Tainted Money" are defined in five sections:

- money transferred by bankrupt 139AI
- Property transferred by bankrupt 139AJ
- Loan discharged by bankrupt 139AK
- Supply of personal services 139AL
- Anti avoidance 139AM

**SECTION 139F: THE COURT'S DISCRETION**

The keynote speaker at the 4th ITSA National Congress[41], at which the Attorney-General announced the release of the BLAAAM, was the Honourable Justice Kenneth Hayne of the High Court of Australia.

It was with some prescience that His Honour, in delivering his keynote address,stated:

> *I note with interest that your website says that the purpose of the Insolvency and Trustee Service is "to provide a personal insolvency system that produces equitable outcomes for debtors and creditors, enjoys public confidence and minimises the impact of financial failure in the country". If these purposes are to be achieved, the law of personal bankruptcy must be an area in which the person at the centre of the process, the debtor, is able to understand what is happening, why it is happening and what consequences follow. Equally, the creditors of that debtor must be able to understand the consequences that will follow for them if their debtor becomes subject to the operation of the Act. Unlike debtors, however, the creditor will be better able to obtain legal advice about its position. In most cases, the debtor will not be able to do that.*
> *There is, then, an evident need for clear articulation of the principles to which the law is intended to give effect. The rules that are to be applied, must, so far as possible, be capable of ready and clear statement. Only then will the debtor be able to understand what is happening, what is to happen, and why.*
> ***That has important consequences for the drafting of applicable legislation. If the relevant principles are clearly articulated, the drafting of legislation will often follow very easily. If the drafting does not follow easily, may this not suggest that the underlying thought is unclear or confused?*** **(emphasis added)**
> .....
>
> *Inevitably there will be proposals for change in the law which provoke debate. Reasonable minds may differ about, not only the form which a change might take, but also the substance of the change itself. Hardly surprisingly, then, compromises are struck and those compromises may even go so far as to paper over some of the underlying difficulties. If that is done, it is inevitable that there will come a time when the courts must struggle to see how the difficulties are to be resolved. One particular way in which difficulties may be obscured is to defer resolution of the problem by giving decision-makers discretions which are informed only by conclusory terms like "fair" and "just". The decision-maker may set aside a transaction in any case where it would be "fair and just to do so". To make such a provision defers resolution of the*

> *problem which underlies it, which is, what are the considerations that are to inform the assessment of what is fair and just? No doubt, over time, a body of decisions will emerge which reveal the kinds of considerations that are thought to be relevant. But that takes time and resources. To follow that path may not always be the best solution available, if only because it delays the solution of the problem to another day and shifts responsibility for the solution to whoever is charged with the task of deciding what is "fair" or "just" or "reasonable".*

Simply put, Section 139F is badly drafted. It fails to meet the basic criteria of sound legislative instrument as espoused by His Honour Justice Hayne. In particular:

- The section fails to state which way the discretionary matters are to be weighted. If there is hardship to a third party, does that mean the Court should or should not make an order against that person?
- There is no definition of hardship. Is this an objective or subjective test?
- There is no definition of benefit. What is meant by an "indirect" benefit? Does the bankrupt receive a benefit if he gives his spouse all of his money who then places it in an account in her name and simply leaves it there untouched by him or her?
- What is meant by "use" of property by a bankrupt?
- What is meant by property being "available" for use by a bankrupt?

These are all key terms and while we might guess at what is intended, this does not augur well for future application.

It is also anticipated that Courts will greet a closed discretion such as section 139F with a degree of caution particularly in hard cases.

**SECTION 139AFA: "TAINTED PURPOSE"**

To prove the existence of "tainted property" or 'tainted money" in relation to any transfer of property (s139AJ), transfer of money (s.139AI), discharge of loan (s.139AK) or the anti avoidance provision (s.139AM) it is necessary to prove that the bankrupt had a "tainted purpose".

It is to be noted that in relation to the provision of services (s.139AL) there is no such requirement. However there is a failure to reconcile that section with the income contribution regime. In particular, on the facts to which section 139AL will apply, a bankrupt will also be assessed for contributions upon his

deemed income under section 139Y of the Bankruptcy Act. This is an extraordinary example of "double dipping"!

Given the need to prove a tainted purpose it is possible these provisions will go no further than the existing sections 120 and 121. While there is a reversal of onus requirement such provisions do not assist a trustee. The experience obtained through the prosecution of claims under section 139ZQ of the Act is evidence of that[42]. It does not take much for a bankrupt and his family to reverse the onus back upon the trustee who will struggle to contradict the sworn evidence of husband and wife.

In addition section 139AFA(1) is misconceived and may prove largely unworkable. If taken with an example of, say a discharge of loan claim, any purpose the bankrupt had in making a payment would be to discharge the loan.

**EXAMPLES OF HOW SCHEDULE 1 WILL OPERATE**

- During the bankrupt's childhood his parents purchased a beach "shack" to enable the family to get away together on weekends.

  Three years prior to his bankruptcy and knowing of his gambling addiction, but wishing the holiday house to remain available to their grandchildren, the parents transfer the property to a trust for "natural love and affection," naming the bankrupt as 1 of 2 discretionary beneficiaries with his sister.

  The bankrupt and his family, and his sister and her family, each share the use of the property throughout the year. The bankrupt is a self-employed mechanic who developed a medically recognised gambling addiction after returning from service from the Vietnam war. He went bankrupt due to gambling debts.[43]

  The holiday house would be caught by section 139AM and subject to a claim by the bankrupt's trustee. This is notwithstanding that at no stage has the bankrupt owned an interest in the property and nor did his parents ever intend that he own an interest in the property.

  The parties may also incur a capital gains tax liability they would not otherwise have accrued by virtue of any sale of the property.

- Tony and Mary migrated to Australia from Italy in the 1950's. After 15 years working Joe and Rita realised their dream of owning and running their own small orchard. Twenty years later their tiny orchard was now several adjoining orchards of some size.

  In 1998 Tony and Mary's first son Robert was married. Robert was employed on the farm and as a wedding gift, and to keep Robert on the farm to look after his parents in their old age, Tony and Mary gave Robert

half of the now unencumbered lands, including the old homestead. Tony and Mary continued to live in the old homestead.

Also in 1998 Tony and Mary's second son, Joe, started a trucking business and was carting fruit and vegetables to the city markets. Tony and Mary were persuaded by Joe to go guarantor for his trucking company's liabilities to his finance company and put up the balance of their property as security. Joe's business failed and due to a shortfall on the sale of the security, after calling in the guarantee, Tony and Mary were made bankrupt.

Pursuant to section 139AJ:

- the bankrupt transferred property before bankruptcy;
- given the existence of the guarantee the trustee seeks to rely upon 139AFA(4) transferring the onus of disproving intent upon Robert;
- it is not an exempt full value transfer; and
- the bankrupt continues to derive a benefit from the property from living on the property.

If Robert cannot displace the onus of proof the property will be subject to attack. This is notwithstanding that Robert has kept his end of the bargain in staying on the land, looking after it and his parents.

- In 1998 Tom married Liz. Tom was a senior lawyer with a large city law firm. Liz was a successful project manager with a large international finance company.

By 2001 Tom and Liz had two children and it was no longer economically possible for them both to continue working with the cost of childcare. After some debate it was agreed that Liz would put on hold her career and pass up a lucrative offer to work overseas for three years. Liz, and not Tom, would stay home to raise their children.

At this time Liz and Tom bought a home, which was registered in Liz's name. Tom and Liz agreed that it was to be Liz's house to provide her with the comfort that she and the children would always at least own the roof over her head. Also at this time Tom was appointed junior partner with the firm.

Over the years Liz raised the children and kept the house. Tom worked hard, at least getting to see his wife and children on weekends. Six years later after one of Tom's partners ran off with the contents of the trust account, for which the partnership was unable to insure, Tom and each of his partners, went bankrupt. The ATO was not a creditor. Tom had paid the mortgage on the house since its purchase.

- Pursuant to section 139AK:

- the loan for the property was a designated borrowing;
- the bankrupt paid money to Liz or in payment of the mortgage;
- the trustee will allege that the bankrupt had a tainted purpose in making the payment
- the transfer was not an exempt full value transfer; and
- the loan was reduced as a result thereof.

If the bankrupt can not overcome the burden of proof in relation to the tainted purpose the house will be subject to a claim from the bankrupt's trustee. Liz however had given up her career, raised their children and kept house for Tom's benefit. In the event of a claim Liz determines to leave Tom so as to bring a claim under the new Schedule 2 provisions.

- The LIV can provide at least one factual scenario by which a high income professional might successfully defeat the objectives of Schedule 1. For obvious reasons that scenario has not been detailed herein given this submission will be distributed publicly. The scenario was suggested by the LIV representative at the Drafting Workshop on 4 February 2004.

**PRACTICAL CONCERNS**

- If a trustee obtains a judgement under the new provisions against say, an overseas based trust, will the overseas courts recognise and enforce such judgements?

- Actions under Div.4A are likely to be costly and time consuming to prosecute. Given the historical reluctance of the ATO to fund trustee actions in anything other than high profile administrations who is going to fund the costs of these matters? If the ATO is bent upon closing a perceived loophole in its own interests, will it undertake to fund appropriate claims of trustees?

- Given the open ended terminology used in the BLAAAM there are likely to be significant issues of proof for a trustee. While trustees have the benefit of public examinations prior to issuing any recovery proceedings it is likely that issues as to proof will create problems similar to those confronting trustees under the existing Div.4A of Part VI.

## CONSTITUTIONAL ISSUES

Placita 51(xvii) (the "bankruptcy and insolvency power") and (xxxix) (the "incidental power") of the Constitution must be read with placitum 51(xxxi) which authorises acquisition of property but only on "just terms".

The proposed Div 4A of Part VI will be "read down" so as to prevent its potential operation as a law authorising expropriation of an entity's property (title to which would otherwise be indisputable and fully protected by the laws of Australia) otherwise than as necessary for, or incidental to, laws for the

peace, order and good government of the Commonwealth with respect to bankruptcy and insolvency matters.

Thus, the reference to "the bankrupt's creditors" in the proposed s.139AFA will be read down so that it has no greater scope than the expression "the transferor's creditors" used in the existing s.121. That is to say, the pejoratively expressed "tainted purpose" which is an essential element of all the proposed claw-back provisions apart from s.139AL, will necessarily be construed as contemplating an intention to defeat or delay existing, future or "anticipated" creditors. (Such an intention is already impugned by s.121. And, proposed s.139AL appears inconsistent with the ambitions of the authors of the Taskforce Report in that it targets personal services rendered to the associated entity rather than, as one would have expected, the clients of the high income professional).

The simple constitutional fact remains that s.120 (which impugns honest but voluntary transfers made without insolvency in mind to a maximum period prior to commencement of bankruptcy of only two years) already stretches the limits of the federal bankruptcy and insolvency and incidental powers. (This is because the constitution was framed in light of existing bankruptcy and insolvency laws which permitted avoidance of voluntary transfers effected within a limited period before bankruptcy providing the transferred money or property was traceable into extant assets).

Apart from the "reverse onus" to be imposed by s.139AFA(2), (4) and (6) [which could easily be added to s.121 anyway], these cumbersome, long-winded and pejorative provisions, when construed in accordance with the Constitution are unlikely to add any utility to ss.120 and 121 as they presently stand.

## RETROSPECTIVITY

### SUMMARY

- The LIV opposes the retrospective operation of Schedule 1 to BLAAAM.

### RECENT EXAMPLES OF THE GOVERNMENT'S OPPOSITION TO RETROSPECTIVE LEGISLATION

- On 12 February 2004 the Prime Minister announced changes to the Commonwealth Parliamentary Superannuation Scheme[44]. The Government refused however to make such changes retrospective on the grounds that it was inappropriate to alter persons prior accrued rights.

- On 16 February 2004 the Prime Minister informed the Parliament:
  ***JOHN HOWARD**: Mr Speaker I have indicated on behalf of the Government that we will introduce legislation. The legislation will not*

*have any retrospective effect. Mr Speaker* ***I think it is a fair and reasonable and entirely defensible, indeed well arguable proposition that people who enter into an arrangement or a part of their career on a certain basis are entitled to enjoy the entitlements of that arrangement as they enter into them.*** [45]

- On 9 March 2004 the Attorney-General released the following press release in relation to making retrospective laws:

> *The ALP has not backed away from its tacit support for retrospective criminal laws the Attorney-General Philip Ruddock said today.*
> *"In debate in the Senate yesterday on the International Transfer of Prisoners Bill, Labor again argued for the two Australians held at Guantanamo Bay to be brought home for trial," Mr Ruddock said.*
>
> *"This is despite being made aware on a number of occasions that there is no prospect of a successful prosecution under the current laws.*
>
> *"The only way Labor could achieve this is to make the laws retrospective and they are also well aware of the difficulties that would bring.*
>
> *"Labor is speaking in code when it advocates that options be explored for the return of the detainee and that is code for retrospectivity.*
>
> *"The Government does not support that course of action and Labor* should be more open about its policy," Mr Ruddock said

- The Government's stated position with respect to retrospective legislation, as noted above, is in stark contrast to the position it is advocating with respect to the operation of the BLAAAM.

**OPERATION OF SCHEDULE 1**

- Schedule 1 to the BLAAAM will operate with respect to "all bankruptcies current on or after the commencement"[46].

- The operation of this provision is likely to be read down in so far as it might be interpreted as having retrospective operation. In this regard the term "current bankruptcy" is nonsensical, having no definition or meaning within the broader operation of the Bankruptcy Act. A person becomes bankrupt and is in due course discharged from bankruptcy. However the bankruptcy administration does not terminate upon discharge and in fact continues for 20 years.[47]

- There is a six year limitation provision in bringing any claim under the new provisions which will limit the ability of a trustee to bring any claim in an existing bankruptcy at the commencement of the amendments.

- There is no provision restricting a trustee who has previously brought an unsuccessful application under section 120 or 121 of the Bankruptcy Act from bringing a fresh application on the same facts under the new provisions. This places an unjust burden on a potential respondent!

- The Bill does not impose any limitation on the date an impugned transaction occurred before a trustee could make a claim.

- As an example, presume a farmer who becomes bankrupt on the commencement of the Bill due to crop failure arising out of the ongoing drought conditions. Twenty years earlier the Bankrupt transferred part of the farm holdings to his children as a way of succession and ensuring the family "stayed on the land". The children worked on the farm, gave up the opportunity of tertiary study and other careers and had always understood they would succeed their parents. The father, since the transfer, continued to assist the children with farm management and was permitted to continue to agist stock. On these facts it would appear that the transfer of property would be subject to the proposed regime and the children liable to attack from a trustee.

- The stated reasons for giving the provisions retrospective operation[48] fails to address at all the issue of accrued rights of individuals and the impact that undoing entrenched arrangements may have upon the innocent respondent from a taxation perspective.

- The LIV strongly opposes any such move to enact legislation having a retrospective effect of this nature.

## PROPOSED ALTERNATIVES

### STRENGTHENING SECTIONS 120 & 121

The principle objection taken by the LIV to Schedule 1 of the BLAAAM is that it seeks to vest third party property in the trustee for the benefit of creditors when the usual connection to bankruptcy (being insolvency and intention to defeat creditors) is not otherwise apparent.

As the Cummins case showed there is not necessarily anything wrong with the existing bankruptcy laws. The primary issue a trustee will confront is one of proof: how does the trustee prove the bankrupt's intention at a time long past when documents may be long destroyed?

These problems can be acceptably addressed without damaging the integrity of our bankruptcy laws by amending the existing sections 120 and 121 to add a number of rebuttable presumptions. In particular:

- Where the debtor fails to lodge a tax return in circumstances where the debtor was obliged to do so and otherwise had a tax liability for that period it can be presumed, for the purpose of section 120 and section 121 (subject to the respondent proving otherwise), that the bankrupt was insolvent at (or within a period about) that time.

- Where the debtor was obliged by law to do so but fails to keep or preserve proper books and records it can be presumed for the purpose of section 120 and section 121 (subject to the respondent proving otherwise) that the bankrupt was insolvent at (or within a period about) that time. Such provision would need to reconcile with the bankrupt's obligation to retain books and records[49].

- "Transfer of property" (ss.120(7)(a) and 121(9)(a)) - This definition should (in the light of *Mateo*[50] and *Houvardas v Zaravinos*[51] be expanded so that it "includes any settlement, alienation, disposition mortgage or encumbering of property and any payment of money".

- Paramountcy of ss.120 and 121 - Also because of *Houvardas v Zaravinos* etc, a new sub-section 9(2) should be inserted to the following effect: "It is intended that ss.120 and 121 cover the field in respect of the avoidance of antecedent transactions".

- The perceived problem would be solved by the addition of the following paragraph (aa) before each of paragraphs 120(7)(b) and 121(9)(b): "(aa) a person who effects a transfer of property that results in another person becoming the owner of property otherwise than for market value is taken to have transferred the latter property to the other person".

- Third party consideration and interaction with s.122 - New paragraphs 120(5)(e) and 121(6)(e) should be inserted: "without limiting the operation of s.122, if and only if the transferee was an associated entity of the transferor at the time of the transfer and the transferee fails to prove that the transferee was at that time unaware that the transferor was, or was about to become, insolvent, past consideration".

Division 4A would require no change if ss.120 and 121 are amended as suggested above.

**ELIMINATING USE OF BANKRUPTCY AS A MEANS OF AVOIDING PAYMENT OF TAX**

In relation to the primary concern of the ATO that high income professionals use bankruptcy as a means to avoid payment of tax, it is suggested that this concern can be addressed by amending section 153 of the Bankruptcy Act.

Subject to an order of the Court, the liability of a bankrupt under a maintenance agreement is not released upon discharge from bankruptcy. Section 153(2A) currently provides that

*The Court may order that the discharge of a bankrupt from bankruptcy shall operate to release the bankrupt, to such extent and subject to such conditions as the Court thinks fit, from liability to pay arrears due under a maintenance agreement or maintenance order.*

It is suggested that a new section 153(3A) be introduced that provides:

- The trustee or the ATO may apply to the Court for an order that a provable debt to the ATO not be released upon discharge from bankruptcy;
- The power of the Court to make an order would need to be limited to cases where there is evidence of abuse such as where there has been a persistent failure to lodge a tax return at some period predating bankruptcy at a time when there was an obligation to do so and a corresponding liability for tax.
- The Court's discretion may need to be prescribed but would be capable of exercise subject to the imposition of conditions.
- A bankrupt should be able to come back before the Court at a later date to vary any order made.

If the tax debt is never released the ATO will be able to garnishee wages and entitlements after the discharge from bankruptcy until such time as the tax debt is paid in full. This should remove any reason for a tax debtor to go bankrupt as a means of eliminating a tax debt as that debt will survive the bankruptcy.

The draft proposal would need to be qualified to ensure persons are not penalised merely because of late filing of returns.

It is recognised that this provision may contravene fundamental policy requirements of bankruptcy and insolvency laws. If, however, it is concluded that some change must be made to protect the ATO from a perceived shortcoming in the Bankruptcy Act such a provision would target the problem, being restricted to those cases of abuse which have been the cause for concern.

## SCHEDULE 2: BANKRUPTCY VS FAMILY LAW

### SUMMARY

- The disparate policy objectives of family law and bankruptcy are difficult to reconcile.
- The IRC opposes the proposed amendments in Schedule 2 to the BLAAAM by which the claims of the parties to the marriage, and the trustee, to any property are resolved by a statutory "carve out" as it unfairly denies the legitimate claims of innocent creditors.

- The FLS supports the granting of a statutory carve out of interest to the non-bankrupt wife as the status quo exposes the non-bankrupt spouse to having to prove a claim in equity (or otherwise) as against the property of the bankrupt.
- The IRC recognises the arguments in favour of a carve out but considers that any resolution of these disparate policies should only be reached after an overall review of the property that is to be available to creditors.
- While the Family Court may be favoured as the jurisdiction in which to determine these claims an issue arises as to which court will consider de-facto claims.

**THE BANKRUPTCY VS FAMILY LAW CONFLICT**

The *Family Law Act* is concerned with the adjustment of property rights and the provision of maintenance in the context of a family breakdown. The Family Court of Australia, in making orders for the proper provision of maintenance[52], or the declaration or adjustment of interests in property[53] must act in accordance with the statutory guidelines[54] for the purpose of achieving a "just and equitable" settlement as between the parties.

The FLA policy objectives have a tendency to clash with the bankruptcy policy objectives when a court is required to determine the competing rights of the non-bankrupt spouse and trustee in bankruptcy, where the trustee seeks to set aside an order of the Family Court made prior to bankruptcy in which the non-bankrupt spouse has been granted an interest in the bankrupt's property.[55] The conflict is likely to become exacerbated with the introduction of *Binding Financial Agreements* between spouses to a marriage[56] which do not require the imprimatur of a court before they become binding upon the parties.

It is a well founded principle of family law that the Family Court is to have due regard of the interests of creditors of the parties before it in making any orders under section 74 or section 79. In *DCT v Rowell*[57], McCall J held;

> *The first step accordingly, in any property proceeding is to ascertain the property of the parties and to ascribe that property a value. In doing so, the Family Court has, in my view quite properly in the past, taken into account liabilities of the parties and made orders which operated on the net value of the property so found. Family Law does not operate in a vacuum. By that I mean the legitimate rights of third parties are not ignored when determining the rights to property between the husband and wife inter se.*

Therefore, to the extent any orders sought might affect the interests of third parties, including creditors, there is a positive obligation upon the parties to bring such matters to the attention of the Court.

A creditor aggrieved by any order made in the Family Law jurisdiction under section 74 or 79 may apply to set aside such orders (or intervene in proceedings where they first come to the creditor's notice). In *Chemaisse v DCT,*[58] a Full Court of the Family Court confirmed the setting aside of a maintenance order on the application of the Deputy Commissioner of Taxation by which a ¾ interest in the family home had been transferred by the husband to his wife. In that case the DCT had obtained a *mareva order* against the husband. Immediately thereafter orders were made by consent under the FLA by which the husband disposed of his interest in property. Neither the husband nor wife disclosed the claim of the DCT in that proceeding. The Court held that "fraud" need not be a fraud on a party and that it was sufficient to show fraud on the part of only one party.

**PROPERTY SETTLEMENTS**

Sections 79 and 75 of the *Family Law Act* provide the basis for the alteration of property interests as between husband and wife. These provisions go beyond normal equitable principles that would apply, for example, to a couple in a de facto relationship at common law. An example of the application of the position that obtains in relation to the latter is *Official Trustee v Lopatinsky*[59]

The IRC of the LIV takes the view that the approach of the High Court in *Baumgartner v Baumgartner*[60] is that which should be adopted when consideration is being given to the rights of a non-bankrupt spouse in the case where the other spouse has become a bankrupt. The reason for taking this view is that bankruptcy involves not only the interests of the bankrupt's spouse and family but also the interests of the bankrupt's creditors. It is the IRC's view that creditors should not be disadvantaged because the bankrupt happens to be married. Indeed, it would be inequitable for the rights of married partners to be treated differently from those of de facto partners. It is noted that the States have enacted legislation conferring statutory rights upon defacto partners similar to those given married couples under the FLA.[61] There is presently a proposal for the States to refer power to the Commonwealth to enable claims of de-facto spouses to be dealt with under the Family Law Act. If all of the types of relationships from which rights might be created in equity and at law can be dealt with in a uniform and consistent way the concerns in this regard may be mitigated.

Having said that, it is to be noted that the Courts are coming to the view that non-financial contributions made by the spouse of a bankrupt may be a relevant factor to be taken into consideration, although just how such contributions can be related to the market value of the property for the purpose of s 121(4)(a) poses a difficulty: *Official Trustee in Bankruptcy v Mateo*[62]

If one is to accept that that non-financial contributions made by the spouse of a bankrupt are a relevant factor, it then becomes a question of putting a figure or a proportion on such contributions. Should there, for example, be a rebuttable presumption for an established relationship that the non-bankrupt spouse should be entitled to a fixed percentage of the property?

The FLS is firmly of the view that a party to a marriage breakdown should be able to apply to the Family Court for a property adjustment notwithstanding the bankruptcy of the marriage partner.

The disparate policies concerning this issue are difficult to be reconciled.

The IRC recognises the benefits of a policy that will lend certainty to all parties concerned. To this end the IRC recognises the general policy in Schedule 2 in that it seeks to balance the rights of the parties to the marriage with the interests of creditors. Concern however does remain as to the manner in which the Family Court will assess the respective claims. There does not appear to be sufficient safeguard against the creditor's interests being totally subordinated to that of the parties to the marriage. To this end the rules applied under the Family Law Act for determination of property and maintenance claims are not apt to dealing with the interests of innocent third party creditors. In this regard there is an additional concern that the new provisions could be a new mechanism used by debtors and bankrupts to avoid payment of creditors. The proposals do not adequately protect creditors in this regard and accordingly the proposals are opposed.

There is likely to be an additional concern for secured creditors who may see secured property being transferred to one party and the release of liability of the other party for the otherwise secured debt. Financial institutions may be justly concerned where the single party may not meet its minimum serviceability requirements.

The IRC submits that to the extent there is to be any legislative carve out of an interest in the bankrupt's property it must fall within the parameters of sub-section 116(2) of the Act and should only take place after an all encompassing review of what property should be exempt from vesting in the trustee in bankruptcy. In this way such carve out can be balanced against such other matters as income and superannuation and the interests of creditors generally.

**JURISDICTION**

Any legislation should deal, not only with the property of married or formerly-married couples, but with the property of persons in de facto and same sex relationships as well. As the Family Court is established under the marriages power of the Constitution, that court could not deal with bankruptcy as it applies to the property of person in de facto or same sex relationships. Logically, therefore, if the Government is bent on applying FLA principles to

bankruptcy, those provisions should be incorporated into the Bankruptcy Act. It follows that, if a superior court is to be vested with jurisdiction, it is the Federal Court, rather than the Family Court, which should deal with all relationships, as little purpose would be served by allowing the Family Court to deal with the property of married or formerly-married spouses and the Federal Court to deal with the property of persons in other relationships. This, perhaps, is merely another argument in favour of vesting jurisdiction in the Federal Magistrates Court. The IRC, however, takes the view that, in any event, appeals should lie to the Full Court of the Federal Court rather than the Family Court.

An alternative arrangement that might be considered would be to confer concurrent jurisdiction on both the Federal and Family Court when matters concerning both jurisdictions arise. This could be coupled with a discretion vested in each Court to transfer appropriate proceedings as between the two courts. For example, if a matter concerned primarily bankruptcy issues was brought in the Family Court it might be transferred to the Federal Magistrates or Federal Court.

### A NEW ACT OF BANKRUPTCY

The LIV is in favour of the proposal (see Schedule 5) that the Bankruptcy Act be amended to insert a new act of bankruptcy to apply where a person is rendered insolvent as a result of assets being transferred pursuant to a financial agreement under Part VIIIA of the FLA. Such a provision would most likely have the effect of a trustee being appointed earlier than might otherwise be the case. It was felt, however, that there might be some difficulty in establishing the act of bankruptcy.

### ALTERNATIVE PROPOSALS

- Section 123(6) - This sub-section should be subjected to s.120 as well as s.121.

- Interaction of Bankruptcy Act and Family Law Act - The necessity for a trustee to go to the Family Court under FLA s.79A would be obviated by the addition of the following paragraph (ab) before each of paragraphs 120(7)(b) and 121(9)(b): "(ab) a transfer of property is taken to include any alteration in the beneficial ownership of property effected by or as the result of the making of any order by a court exercising jurisdiction under the Family Law Act 1975 which order was consented to by the transferor and the transferee or unopposed by the transferor".

## SCHEDULE 3: COLLECTION OF CONTRIBUTIONS

### SUMMARY

- The LIV views the contribution enforcement regime set out in Schedule 3 to the BLAAAM as harsh and oppressive. In so far as the proposals are only intended to operate where the bankrupt has defaulted in his or her obligations, the LIV lends cautious support to them but recommends the application of the provisions be monitored for any unintended or overtly harsh consequences.

- The LIV continues to support the income contribution regime contained in the Bankruptcy Act. However, the LIV invites the Government to review the threshold levels to determine whether undue hardship is being suffered by the bankrupt's family, in circumstances where there is a strict adherence to the contribution regime.

**CONSIDERATION OF PROVISIONS**

It is generally recognised that one of the principal failings of the income contribution regime has been the difficulty a trustee has in recovering contributions from self-employed persons.
The LIV supports the general objective of creating a system whereby bankrupts who are required to contribute to their estate in fact do so.

It should, however, be recognised that where contributions are of a relatively nominal sum (even running up to the several thousand dollars), such contributions will not result in any additional return to creditors, but in the ordinary course will be taken up in trustees fees in conducting the assessment and enforcing it.

There is anecdotal evidence that where the bankrupt is the sole financial provider for a family, even nominal contributions do cause significant hardship for families. It is not suggested that in such cases the bankrupt and their family are living anything but a usual standard of living. If nominal contributions are not returning any benefit to creditors but do cause real hardship there is a case for a review of the threshold levels.

There is a danger that the new provisions, being supported by criminal sanction, will have unintended consequences in some cases. In particular, a bankrupt deriving no cash funds can in certain cases be deemed to have derived income due to the provision of services. It is to be recognised that a bankrupt has a choice whether to work or not, and similarly, the bankrupt's family has a choice whether to support the bankrupt or not. That support does not have to include payment of the contributions on behalf of a bankrupt. Indeed payment of such contributions would in itself be an assessable benefit.

An example of the possible consequences of such provisions:

A bankrupt may choose, rather than working and paying contributions, to cease working and take over the child care responsibilities of the non

bankrupt spouse. The bankrupt is liable then to be assessed for the non-financial benefits he receives, but also, potentially, for the work he or she undertakes as primary care giver to the children of the relationship. If the trustees were to make an assessment and require the opening of a relevant account, the receipt of any funds by the bankrupt from the non-bankrupt spouse potentially have to be paid to that account notwithstanding they are for the benefit of the family at large. Given the criminal sanctions attached to any failure to comply with the direction of the trustee to pay money to an account, there is a concern as to how these provisions may operate in practice.

Accordingly, the LIV recommends that the application of these provisions should be monitored, and similarly, considerations should given to reviewing the threshold levels to ensure that they properly reflect a standard living which will not otherwise cause undue hardship to innocent third parties. In particular, consideration might be given to lifting the base threshold amount while increasing the percentage level of contributions where income exceeds a certain level.[63]

[1] Letter dated 2 June 2004 from the Secretary to the House of Representatives Standing Committee on Legal and Constitutional Affairs to Michael Lhuede of the IRC
[2] Explanatory Memorandum para 9
[3] Taskforce Report para 1.4
[4] See Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act for the Year 2002-2003 where at Table 7, pages 18-20, it details the occupational breakdown of "Business Bankruptcies". Professionals (441) and "Associate Professionals"(473) made up 914 of 4411 identified business bankruptcies.
[5] Australian Law Reform Commission, *General Insolvency Enquiry, Report No. 45*, Australian Government Publishing Service, Canberra 1988
[6] *The Bankruptcy Legislation Amendment Act 1996* ultimately picked up the recommendations of the Harmer Report in relation to the redrafting of the antecedent transaction provisions
[7](2003) 198 ALR 218
(2003) 77 ALJR
[8] Bickerdyce I, Lattimore R & Madge A, *Business Failure and Change: An Australian Perspective*, Productivity Commission Staff Research Paper, Ausinfo, Canberra, 2000.
[9] Wood P, *Law and Practice of International Finance: Principles of International Insolvency*, Sweet and Maxwell, London, 1995.
[10] See Generally the Report of the Committee Appointed by the Attorney-General of the Commonwealth to Review the Bankruptcy Law of the Commonwealth (the Clyne Committee Report) Commonwealth of Australia, 1962 as to a history of bankruptcy law in Australia and the policy behind it to that date.
[11] See note 5 @ para33.
[12] Law Commission (New Zealand), *Priority Debts in the Distribution of Insolvent Estates: An Advisory Report to the Ministry of Commerce*, 1999

13 .s.106YA *Higher Education Funding Act 1988*
14 Section 58A of the Bankruptcy Act 1966 inserted by Act 86 of 2002 which was introduced without referral to the Consultative Forum
[15] The Explanatory Memorandum states that the BLAAAM will "implement a number of key recommendations made in the Joint Taskforce Report...".
[16] The third paragraph of the Executive Summary to the Taskforce Report makes it clear that the Taskforce was established to "consider whether any changes should be made to bankruptcy and taxation laws to ensure bankruptcy is not used as a means to avoid tax obligations."
[17] (No. 6) [2003] FCA 1002 (24 September 2003)
[18] Made 14 May 2004 to the 5th National ITSA Congress
[19] See paragraph 27 of the Attorney General's speech of 14 May 2004 to the ITSA Fifth National Bankruptcy Congress, paragraph 11 of the Explanatory Memorandum and the Executive Summary to the Taskforce Report.
[20] See for example the taxation case concerning the application of Part IVA of the Income Tax Assessment Act in *Mochkin v Commissioner of Taxation* [2002] FCA 675 which endorsed the right of a tax payer to operate a business via a corporate and trust entity for the purpose of limiting liability.
[21] HIH is the easy example but also see concerns surrounding the Medical Defence Funds
[22] Explanatory Memorandum para 9.
[23] Taskforce Report paras 1.8-1.12.
[24] Taskforce Report Appendix 1.
[25] 5.23% would amount to 1145 persons who disclosed their occupation as professional
[26] Profiles of Debtors 2003, p.15, Commonwealth of Australia 2004
[27] Taskforce Report para 1.3
[28] Taskforce Report para 1.8
[29] Profiles of Debtors, p. 13
[30] This appears to be accepted by the Senate Economics References Committee as noted at para 1.15 of the Taskforce Report
[31] For example, see the minutes of Consultative Forum meeting on 4 February 2004

[32] At paragraph 1.20 of the Joint Taskforce Report there is a reference to an article in the Sydney Morning Herald generating public debate surrounding the misuse of bankruptcy laws by Sydney barristers. The serial bankrupt issue has been addressed in the 2002 amendments to the Bankruptcy Act. Further the issue as to whether there was a failure in the enforcement of the bankruptcy laws or the taxation laws is not addressed.
[33] 13 Eliz 1 c 5.
[34] For a detailed history of the law relating to the setting aside of antecedent transactions in insolvency, see the judgement of Priestly JA in *Harkness v Partnership Pacific Ltd* (1997) 41 NSWLR 204.
[35] See generally Australian Law Reform Commission, *General Insolvency Inquiry*, Report No.45, Australian Government Publishing Service, Canberra, 1988.
[36] Section 120 of the *Bankruptcy Act 1966* ("the Act").
[37] Section 121 of the Bankruptcy Act.
[38] Section 122 of the Bankruptcy Act.
[39] See section 27 and section 35A of the Bankruptcy Act that permits the transfer of proceedings in bankruptcy to the Family Court of Australia.
[40] (2003) 198 ALR 218; (2003) 77 ALJR
[41] held 13-14 May 2004
[42] See for example the comments of Wilcox J in *In Re Pearson; Ex parte Wansley* (1993) 46 FCR 55
[43] Members of the IRC can relate an actual case from some years ago which is not unlike the example given and upon which it is based.
[44] see The Australian newspaper article of 13 March 2004 reported by Steve Lewis and Dennis Shanahan
[45] Canberra, House of Representatives, Parliamentary Debates (Hansard) 16 February 2004 @24759
[46] Section 5 of Schedule 1
[47] Section 127(1) of the Bankruptcy Act 1966
[48] Paragraph 89 of Explanatory Memorandum
[49] See for example section 270 of the Bankruptcy Act
[50] [2003] FCAFC 26
[51] (2003) 202 ALR 535
[52] Sections 74, 86 and 87 of the FLA.
[53] Sections 78 (declaration of interest) and 79 (alteration of interest) of the FLA.
[54] Sections 75 (maintenance proceedings) and 79(4) (alteration of property interests).
[55] The conflict will also arise when a non-bankrupt spouse seeks to claim the protection of a property adjustment order after the date of bankruptcy. It is not the purpose of this submission to consider in any detail the equitable remedies available to the non-bankrupt spouse in such cases. The title of the trustee in bankruptcy to the bankrupt's property is subject to the equitable rights of third parties: *Re Goode; Ex parte Mount* (1974) 4 ALR 579. The non-bankrupt spouse might seek to assert an equitable right in property otherwise registered in the name of the bankrupt pursuant to a constructive trust (*Baumgartner v Baumgartner* (1987) 164 CLR 137), the equitable right of exoneration (*Parsons v McBain* (2001) 109 FCR 120), or equitable estoppel (*O'Brien v Sheahan* [2002] FCA 1292) or seek to rely upon the equitable presumption of advancement (*Calverley v Green* (1984) 155 CLR 22 or such other equitable rights arising prior to bankruptcy. The ability to obtain declaratory relief in respect of such claims could be given under the Bankruptcy Act (section 30) or the Family Law Act (section 78).
[56] See Part VIIIA of the FLA introduced by the Family Law Amendment Act 2000 (No 143 of 2000).
[57] (1989) FLC 92-026; See also *Ascot Investments Pty Ltd v Harper* (1981) 148 CLR 337
[58] (1990) 97 FLR 176
[59] (2003) 1 ABC (NS) 271
[60] (1987) 164 CLR 137
[61] See for example the Part 9 of the *Property Law Act 1956* (Vic)
[62] (2003) 127 FCR 217