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Ref: GMR:vc

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12 July 2004

<i>Bankruptcy</i>
Submission No: <i>102-1</i>

Dr Mal Washer MP  
Federal Member for Moore  
Parliament House  
CANBERRA ACT 2600

By Facsimile: (02) 6277 8587

Dear Dr Washer

## **BANKRUPTCY LEGISLATION AMENDMENT (ANTI-AVOIDANCE AND OTHER MEASURES) BILL 2004 ("BLAAOM")**

We refer to our submission in respect of the BLAAOM dated 16 June 2004 ("the Pitcher Partners Submission") and to our attendance before the House of Representatives Standing Committee on legal and constitutional affairs on Monday 5 July 2004 ("the Committee Hearing"). You have asked the authors to further expand on the suggested alternatives and recommendations that were made in the Pitcher Partners submission and discussed at the Committee Hearing. We are pleased to offer further information on our alternatives and recommendations and we are grateful for the opportunity to further explain them to you.

At the outset we advise that it is our view that much of the concerns expressed about the BLAAOM would be addressed by focusing the attention on a perceived weakness in the current bankruptcy legislation namely, the failure to prevent high income earners using bankruptcy laws as a means to avoid tax liabilities. Two main recommendations are both designed to specifically address this perceived concern, without a major revamp of current bankruptcy law and practice. Both the "Special Act of Bankruptcy" (refer 8.1.2 of the Submission) and the Presumption of Insolvency (refer 8.1.3 of the Submission) recommendations are means by which current bankruptcy law is "tweaked" to allow an effective way for a Trustee in Bankruptcy to recover property from high income individuals who do not lodge tax returns and/or pay their taxes and use bankruptcy to avoid payment of taxes.

Currently a trustee in Bankruptcy is armed with provisions that operate to "set aside", that is, render void, transactions that are entered into for less than market value and are entered into either two years prior to the "commencement" of bankruptcy or if insolvent, within five years from the "commencement" of bankruptcy. Under bankruptcy law the "commencement" of bankruptcy is deemed to have taken place upon the creation of the first available "Act of Bankruptcy" within 6 months from the date of the petition for an individual's bankruptcy. The "Acts of Bankruptcy" are



defined within the Bankruptcy Act (Section 40) and are in effect a public notification of the fact that an individual is insolvent. The most common Act of Bankruptcy is the failure of an individual to meet the terms of a Bankruptcy Notice which typically requires the individual to, amongst other things, pay a judgement debt within 21 days from the service of the Notice on the individual. The Act of Bankruptcy is said to have been committed upon the expiry of the terms of the Bankruptcy Notice. The Bankruptcy would normally therefore "commence" on the day that the Bankruptcy Notice has expired, that is, the 21<sup>st</sup> day after the service of the Bankruptcy Notice becomes the day upon which an Act of Bankruptcy is said to occur.

Consequently the "commencement" of Bankruptcy and the date of Bankruptcy (that is the day the individual is made a bankrupt by virtue of an order of the Court or by virtue of the acceptance of that individual's own petition for Bankruptcy) are often different dates. The commencement of Bankruptcy is often a date sooner than the date of Bankruptcy.

It should also be noted that the rules relating to the "commencement" of Bankruptcy also have the effect that property transferred by a Bankrupt after the "commencement" of Bankruptcy but before the date of Bankruptcy is property of a Bankrupt Estate and accordingly a Trustee in Bankruptcy will have a better right of claim against such property (refer Section 115 of the Bankruptcy Act). We do not propose that this Section apply when a Special Act of Bankruptcy is to be relied upon by a Trustee in Bankruptcy because it is quite possible that Special Acts of Bankruptcy will have the effect of "commencing" a Bankruptcy many years prior to the date of Bankruptcy and it would be inappropriate for property disposed of between the "commencement" of Bankruptcy and the date of Bankruptcy to be dealt with in anyway other than the law currently prescribes.

The importance of the commencement and its main purpose is to assist a Trustee in Bankruptcy in recovering property that has been transferred prior to the date of Bankruptcy for the benefit of creditors. The most important recovery provisions are Sections 120 and 121 of the Bankruptcy Act. Section 120 contains the two year and the five year rules referred to above.

Section 121 provides for an unlimited time frame by which a transaction can be "set aside" if it can be shown that the bankrupt's main purpose in making the transfer was either:

- to prevent the transfer property from becoming divisible amongst his/her creditors ("prevention"); or
- to hinder or delay the process of making property available for division amongst his/her creditors ("hindrance").

Although there is no reference to evidence of insolvency in the section, the section itself notes that the transferors main purpose is said to be prevention or hindrance if the transferor was, or was about to become, insolvent at the time of transfer.

In essence what this means, from a practical point of view, is that, **in order to recover property that has been transferred for less than market value for any period greater than two years prior to the commencement of bankruptcy, a Trustee in Bankruptcy must show that the individual was insolvent (or was about to become insolvent) at the time of transfer.** The longer the period between the time of transfer and the commencement of bankruptcy, the greater the difficulty a Trustee in Bankruptcy will have in showing that the individual was insolvent or was



about to become insolvent at the time of the transfer. This is due to legal constraints (the need to keep records) and practical constraints (the ability to recall events or obtain other evidence).

A Special Act of Bankruptcy would operate to commence the bankruptcy at a date much earlier than current Acts of Bankruptcy allow. In the case of an individual who was deliberately avoiding lodging tax returns or paying tax liabilities, this would have the effect of commencing the bankruptcy, in many cases, years prior to the date that the person actually becomes a bankrupt. The presumption of Insolvency would operate so that where a Trustee in Bankruptcy seeks to rely upon a Special Act of Bankruptcy, then the fact that tax returns had not been lodged would "trigger" the presumption that the bankrupt was insolvent at that date and for the period between the date of bankruptcy and the date of the Special Act of Bankruptcy. The onus would remain with the bankrupt to rebutt the presumption and prove that at the relevant date he or she was solvent and was not about to become insolvent. This is a significant weapon that a Trustee could use when dealing with transactions that may have occurred beyond the time frame by which the law requires records to be maintained.

We have attached a hypothetical example which will help illustrate how these provisions will work. We stress that a Trustee in Bankruptcy that uses a Special Act of Bankruptcy and the Presumption of Insolvency as the means to recover assets/property, will be recovering the said assets/property for the benefit of ALL creditors of the bankrupt estate including the Deputy Commissioner of Taxation.


We believe that the recommendations suggested are sufficient to adequately address the perceived failure of current bankruptcy legislation to prevent high income earners using current bankruptcy laws as a means to avoid tax liabilities. We believe, for the reasons given in the submission, that the proposed amendments to the Bankruptcy Act are inappropriate and would cause unnecessary financial and emotional hardship and uncertainty to small business owners, directors of charitable and non - charitable institutions and professionals.

We would be pleased to answer any further questions that you or the Committee may have.

Yours faithfully  
PITCHER PARTNERS



**G M RAMBALDI**  
Partner



**A R YEO**  
Partner

cc: Mrs Bromwyn Bishop  
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### **EXAMPLE: High Income Taxpayer Using Bankruptcy to Avoid Paying Tax**

1987	Taxpayer transfers house property to wife
1989	Taxpayer transfers shares, motor vehicles and cash deposits into family trust
3 June 1991	Taxpayer fails to lodge Income Tax Return (earliest Special Act of Bankruptcy) for financial year ended 30/6/90
1992-1999	Taxpayer fails to lodge Income Tax Return for financial year ended 30/6/91 to 30/6/99
1999	Income Tax Assessment Notice issued
2000	Judgement obtained by Deputy Commissioner of Taxation
2001	Bankruptcy Notice issued by Deputy Commissioner of Taxation
1 September 2001	Last date for compliance of Bankruptcy Notice issued by Deputy Commissioner of Taxation
1 October 2001	Petition lodged by Deputy Commissioner of Taxation for Sequestration Order against estate of taxpayer
1 December 2001	Sequestration (Bankruptcy) Order made against estate of Taxpayer

#### **Under Current Bankruptcy Law**

- Act of Bankruptcy occurs on 1 September 2001
- Bankruptcy "commences" on 1 September 2001
- 2 year "clawback" operates for period 1 September 2001 to 1 September 1999
- 5 year "clawback" operates for period 1 September 2001 to 1 September 1996
- Only Section 121 could apply but must, in practice, show insolvent status or possibility of insolvency, in this example, at a date greater than 10 years before the "commencement" of bankruptcy
- Likely result – no recovery of property for the benefit of creditors

#### **Under revised bankruptcy law which incorporates a Special Act of Bankruptcy and a presumption of insolvency**

- Special Act of Bankruptcy (SAB) occurs on 3/6/91 - date that taxpayer failed to lodge Income Tax Return (the SAB cannot be used to found a petition for bankruptcy but is used to "clawback" property – 2 year, 5 year and longer, see below)
- Presumption of Insolvency operates to presume that the taxpayer was insolvent from 3/6/91 to the date of bankruptcy (rebuttable).
- 2 year "clawback" operates for period 3/6/1991 to 3/6/1989 (no requirement to show insolvency)
- 5 year "clawback" operates for period 3/6/1991 to 3/6/1986 (requirement to show insolvency)
- Likely result – recovery of property for benefit of all creditors of the bankrupt estate