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The Institute of Chartered Accountants in Australia

17 June 2004

Committee Secretary
House of Representatives Standing Committee
on Legal and Constitutional Affairs
Parliament House
CANBERRA ACT 2600

Email: laca.reps@aph.gov.au

**SUBMISSION TO THE STANDING COMMITTEE ON LEGAL AND CONSTITUTIONAL AFFAIRS - INQUIRY INTO THE BANKRUPTCY LEGISLATION AMENDMENT (ANTI AVOIDANCE AND OTHER MEASURES) BILL 2004**

I refer to your letter dated 2 June 2004 to Ms Alison MacDonald inviting the Institute Of Chartered Accountants in Australia ("ICAA") to comment in relation to the Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004 ("the Bill"). We appreciate the opportunity to submit our comments, which are set out below.

**ICAA Does Not Support Unscrupulous Debtors**

The ICAA supports the policy objectives of the Bill set out in the Explanatory Memorandum as they relate to taxation obligations namely "to address the issue of high income professionals using bankruptcy as a means of avoiding their taxation…….obligations". In particular, the ICAA supports steps aimed at "the problem of a small but significant number of high income debtors, typically high earning fee-for-service professionals, who use bankruptcy to avoid paying their taxation…….debts". In referring to these debtors the Explanatory Memorandum notes that "these debtors have the ability to pay their debts but instead fund a lifestyle made possible only through the non-payment of debts and the build up of assets in the name of related parties".

In providing our support we have specifically deleted reference to "other obligations and debts". Although the terms of reference for The Committee include consideration as to whether the provisions of the draft Bill adequately address taxation and other debts/obligations we note that the Bill is a response to taxation obligations/debts identified in a Joint Task Force report entitled "The Use of Bankruptcy and Family Law Schemes to Avoid Payments of Tax".

The report of the Joint Task Force was specifically concerned with the conduct of some lawyers using "bankruptcy to avoid paying the tax that they owe according to the law".

**Unintended Consequences Of The Bill**

In our view the provisions of the draft Bill should be limited to dealing with activities of the type referred to by the Joint Task Force.

As presently drafted the Bill is far too broad in its application and would unfairly result in legitimate arrangements for professionals in business to deal with exposures arising from gaps in professional indemnity insurance cover being ineffective. In addition, many small business owners and retirees who operate as sole traders or partners in a partnership and have put in place similar arrangements to protect their families in the event of their business becoming insolvent due to circumstances beyond their control would also be affected.

These people are not using "bankruptcy to avoid paying the tax they owe according to the law". Given this, we consider that those provisions of the Bill which as noted in the Explanatory Memorandum would result in a "fundamental shift" away from the perceived legitimacy of "arrangements of the type which are potentially within the scope of the new provisions", are unreasonable.

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## Retrospective Legislation Is Especially Unfair

Many of our members act for small business people taking risks in starting up and operating businesses in which they work long hours. Despite their honest, best efforts some of these businesses fail. A number of these small business operators include middle-aged people who having been retrenched and finding difficulty in obtaining alternative employment have gone into business on their own account. Others include older age workers who having been encouraged by all political parties to remain in the work force longer have elected to defer their retirement. None of these people are "using bankruptcy to avoid paying the tax they owe according to the law". Yet under the Bill assets they have accumulated in previous years over the course of their working life and to support them in retirement, will be exposed irrespective of whether they have previously met all their tax obligations.

At the very least, these people should be entitled to expect that any asset protection arrangements, which they adopted in previous years, based on the law at that time should continue to be effective. We have great difficulty in reconciling the retrospective nature of the proposed changes given The Prime Minister's comment in answer to a question from The Leader of the Opposition on Monday, 16 February 2004 and as reported in Hansard on page 24538, regarding the Parliamentary Superannuation Scheme. The Prime Minister said in response to the Leader of the Opposition's question "…..it is a fair, reasonable and entirely defensible and indeed, well-arguable-proposition that people who enter into an arrangement or part of their career on a certain basis are entitled to enjoy the entitlements of that arrangement as they entered into it". The Prime Minister's comments suggest that it is the government's policy not to embark on retrospective legislation such as that set out in the Bill.

Similarly the provision to reverse the onus of proof by incorporating the concept of a rebuttable presumption is another example of where the Bill transgresses generally accepted and time honoured precedent. The Bill clearly places on the bankrupt the burden of rebutting the presumption available to the trustee in bankruptcy that the main purpose behind any transfer was a "tainted purpose".

There is no definition of "main purpose". In the ICAA's view, the use of this expression in other "anti-avoidance" provisions has been shown to cause a great deal of uncertainty.

The likely result is that courts must ultimately be called upon to determine whether or not a particular purpose can be inferred from all the surrounding circumstances. This is an expensive and time consuming exercise for all parties, that can simply prolong distributions to creditors, and reduce the overall ultimate pool of funds available for distribution.

In the ICAA's view, it is likely to be very difficult for any bankrupt to be able to adduce concrete evidence that the main purpose behind any particular disposal was not a "tainted purpose". This is particularly so where the transaction occurred many years ago or there are simply no records or persons available to assist the court in its deliberations.

## Professional Accountants And Other Small Business People Adequately Dealt With By Existing Legislation

In its report The Task Force noted the difficulty the ATO had experienced in recovering unpaid income tax from unscrupulous high-income professionals whose bankruptcy did not affect their capacity to carry on their profession.

As indicated in our joint submission with CPA Australia to the Joint Task Force, a copy of which is attached, the By-laws of the ICAA which cover membership of the ICAA stipulate that in the event of a member becoming bankrupt or entering into an arrangement with creditors, the member is subject to disciplinary action which in most cases results in suspension from membership. Whilst this prevents the member from continuing to practice using the CA designation, it does not prevent the member continuing to earn a living as an accountant. However the loss of the right to use the designation deprives the person concerned of a very valuable branding asset with the result that their income earning capacity from practicing as an accountant is likely to be greatly diminished.

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In the case of those involved in small business, bankruptcy has a similar impact on their income earning capacity as it restricts their ability to obtain credit to operate a business. Those that obtain alternative employment come within the ambit of the garnishee arrangements. As a consequence, neither the professionals nor the small business people are in a position to "use bankruptcy as a sword to defeat the legitimate claims of creditors" being the concern expressed in the report of The Taskforce.

We also note that the Taskforce was comprised solely of government agencies. It makes no reference to past or ongoing consultation with those industries and professions that may be affected by any legislation or administrative efforts aimed at dealing with the problems of particular individuals abusing the bankruptcy system to avoid paying tax. Indeed we can find no real evidence to support the conclusion that a number of isolated instances have, in fact, undermined the entire bankruptcy system. Indeed, the statistics set out in the Annual Reports of the Inspector General in Bankruptcy, ITSA and related commentaries do not suggest this has been the case.

**Problems Relate To Tax And Are Better Dealt With By Other Means**

The Taskforce was essentially concerned with the practice by which a group of high income individuals by divesting themselves of their assets proceeded to continue to earn large incomes with the intention of avoiding paying tax on this income by declaring themselves bankrupt upon the ATO seeking to recover unpaid tax. The Bill is therefore designed to assist the ATO in its debt recovery activities. The operation and fairness of the bankruptcy system should not be unfairly changed retrospectively nor the presumption of intent introduced in the absence of "rebutting the presumption" to facilitate the collection of tax by the ATO. This should be dealt with by the Income Tax Assessment Act or the ATO adopting more proactive and timely procedures to ensure that high earning fee-for-service professionals are lodging their tax returns and paying their tax obligations on time. In the event that such people do not discharge their tax obligations and proceed into bankruptcy then we would propose that the existing provisions under section 139A of the Bankruptcy Act be amended to provide for the period of claw back which currently prevails to be extended by one year for every year that a tax obligation is outstanding. Alternatively, the proposed amendments of the Bill should only apply when it could be clearly demonstrated by the trustee that the acquisition of property acquired by the third party using funds or property provided by the bankrupt was designed to avoid the payment of a tax liability.

**Adverse Impact On Employment And Economic Growth**

The Bill will not only impact current professionals and small business operators but will also adversely impact prospective entrants into professions, corporate directorships or small business by discouraging people from entering areas of employment where their ability to protect their families would be jeopardised. This will discourage corporate leadership and the entrepreneurial spirit which is so vital in small and large business and which, particularly makes small business one of the largest engines for employment growth thereby impacting employment and economic growth generally. Indeed the Bill will also impact the ATO in its efforts to encourage greater tax compliance by discouraging people from entering into the accountancy profession which is traditionally the source of many tax agents. The current concerns, which the ATO has about the availability of tax agents in an aging workforce, will be exacerbated.

The Bill will also lead to an increase in professional fees and business costs generally as market prices adjust to compensate for the much higher risk environment.

**Likely Conflict With Settled Law And Other Public Policy Objectives**

Central to the amendments proposed by Schedule 1 is the concept of a 'tainted purpose'. Sect 139 AFA provides that a bankrupt has a tainted purpose in making a payment of money (or a transfer of property) if their main purpose was to prevent, hinder or delay the money (or property) becoming divisible among the bankrupt's creditors, or it can reasonably be inferred from all the circumstances that the bankrupt was, or was about to become insolvent.

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Moreover, the section provides that a tainted purpose is to be presumed, unless the contrary is proved, where the trustee in bankruptcy alleges that the bankrupt had such a tainted purpose.

Sect 139AFB provides exemption for full-value transfers in certain circumstances. The transfer of property for natural love and affection or for a promise to marry or become a de facto spouse is not exempted, as these notions are specifically deemed to have no value.

These provisions potentially have a very wide impact, and could effectively operate to elevate the rights of creditors above the expectations of family members and associates to be provided for in the event that a business or calling undertaken by an income earner who later becomes bankrupt fails, whatever may be the reason for that failure.

If such, a fundamental shift in public policy is intended by government, the ICAA considers that a more principled and structured philosophical debate is first required.

Common law equitable principles, as well as various statutes have long recognised that persons holding assets or earning income would want to transfer some or all of those assets or income to members of their family or to other bodies (such as charitable institutions) for many reasons, other than the avoidance of paying tax or otherwise defrauding creditors. In certain cases, the common law allows for a presumption of advancement, in others, certain statutes historically have exempted from taxes and charges transfers of property where the transfer is made at the time of a marriage in consideration of the natural love and affection between pending marriage partners.

The public policy behind such provisions is understood to be promotion of family life, with dependent partners and minors being adequately provided for, by assets held or income derived by the other marriage partner-independent of the state and in priority to other third parties, including business creditors. This reflects the fact that the major creditors are able, at the outset of any transaction, to inform themselves of the asset and income position of individuals with whom they deal, and to accept certain risks in exchange for certain rewards.

In the ICAA view, the natural desire to properly provide for family members in the event of business failure, for whatever reason, should be promoted by public policy as the best way to ensure that persons seeking to acquire assets or earn income will actively seek to continue to do so. Market economies are based on the notion that such incentives maximise the overall welfare of the community and minimise the likelihood of personal bankruptcy and insolvency in the first instance.

**Implications For Trustees And Other Comments On Technical Aspects Of The Bill**

Many of our members also act as trustees in bankruptcy and are members of the Insolvency Practitioners Association of Australia (“IPAA”). The ICAA supports the submission of the IPAA, which focuses on technical issues and problems that trustees will encounter in attempting to practically implement the Bill.

**Conclusion**

In summary, the Bill:

- Introduces retrospective legislation;
- Reverses the burden of proof to one of rebuttable presumption;
- Adversely impacts not only high-income fee for service professionals, but company directors, many small business people and retirees;
- Disencourages corporate leadership, enterprise and employment;
- Conflicts with settled law and other public policy objectives;
- Seeks to address a problem which is more appropriately dealt with by other means;
- Results in the all above adverse impacts for the limited purpose of addressing the problems of the ATO in collecting tax from a very small number of professionals.

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The ICAA would appreciate the opportunity of meeting with the Parliamentary Committee to further discuss the concerns of our 40,000 members and their clients with respect to the Bill.

Yours sincerely

**Stephen Harrison,** AO
Chief Executive Officer
The Institute of Chartered Accountants
in Australia

Encl.

The Institute of Chartered Accountants in Australia

CPA AUSTRALIA

# JOINT SUBMISSION
# OF

# THE INSTITUTE OF CHARTERED ACCOUNTANTS IN AUSTRALIA
# &
# CPA AUSTRALIA

# TO THE

# JOINT TASK FORCE ON THE USE OF BANKRUPTCY AND FAMILY LAW SCHEME TO AVOID PAYMENT OF TAX

**The Institute of Chartered Accountants in Australia ("ICAA") and CPA Australia ("CPAA") -('the professional bodies') - have considered the proposals that seek to look beyond the legal ownership of assets as detailed in the material produced by the Joint Taskforce on the use of Bankruptcy and Family Law schemes to avoid the payment of tax – the issues paper ("issues paper") released on 21 November 2002 and the report ("the report") released in an edited version on 2 May 2003 – and make the following submission on behalf of our members.**

## 1.0 Executive Summary

1.1 Our bodies represent over 105,000 members who are key providers of business and financial advice. The accounting profession in Australia employs 81,000 people and generates 0.8% of Australia's GDP. More than 12,000 members are company directors and 24,500 members operate in public practice. These members together with the staff of those in public practice are directly impacted by the proposals.

1.2 In our view the proposals to amend the Bankruptcy laws as detailed in the issues paper and report adversely impact upon arrangements under which many accountants have always operated. This will have a significant impact on the number of members remaining in public practice or undertaking the duties of directors and could therefore inhibit economic activity in Australia.

1.3 It is submitted that the proposals to reform the Bankruptcy laws are a draconian response to tax evasion arrangements undertaken by a few taxpayers. ICAA and CPAA through their rules and disciplinary processes already prohibit their members from undertaking such schemes if they wish to continue with the benefits of membership. Accordingly, we cannot support the wide-ranging nature of the reforms that seek to injure the general body of professionals to insure against a repeat of the actions of a few persons undertaking tax evasion.

## 2.0 Rules of professional conduct

2.1 In this regard, we would like to reiterate advice recently provided to ITSA that contrary to the report, the ICAA has specific rules that would impose a penalty or consequence should a member of the ICCA become bankrupt. Those rules are attached (annexure 1). They provide comparable sanctions to those of CPAA as detailed in the original report.

2.2 The significance of these rules is that for members of the professional bodies, contrary to the contention implied in the report, bankruptcy **does** affect the bankrupt's capacity to carry on their profession. If excluded, our members are not able to use the designation CA or CPA. Although it is correct, as stated in the report at page 66, that loss of accreditation does not prevent a person from practising as an accountant, the designation is very valuable and not something easily foregone. Furthermore bankruptcy will result in loss of registration as: i) a company auditor as regulated by The Australian Securities and Investment Commission; and ii) a registered Tax Agent. Unless registration as a tax agent is maintained it is an offence to charge a fee for preparing income tax returns or transacting any income tax business. Registration of a tax agent is cancelled if the tax agent becomes an undischarged bankrupt (section 251K (3C) of the Income Tax Assessment Act 1936). Accordingly, bankruptcy would significantly reduce the income earning potential of an accountant in public practice and is therefore an arrangement that such members seek to avoid.

2.3 The professional bodies have established a self-regulatory framework to create and maintain the professional standards for members. Features of this framework include high entry standards, continuing professional education requirements, and comprehensive professional standards of quality and service to their clients maintained though regular quality reviews of practices.

2.4 The Trustee in Bankruptcy is usually a member of the professional bodies and should an ICAA or CPAA member be declared bankrupt the trustee will inform members to advise the professional conduct division of the professional bodies who then conduct an investigation and hearing usually resulting in forfeiture or suspension of membership.

## 3.0 Importance of structures for protecting the private assets of members of the professional bodies.

3.1 The Government legislates to prevent audit firms from incorporating. Hence auditors are unable to gain the protection of limited liability available to other commercial enterprises through incorporation. Professional indemnity insurance is becoming increasingly expensive to acquire and more importantly gaps arise in the cover such that accountants are directly exposed to claims for negligence. Such claims can lead to bankruptcy of members of the professional bodies where there is clearly no intention to avoid tax.

3.2 Traditionally there have been accepted and legal arrangements for professionals in business to deal with such professional indemnity issues. The issues paper acknowledges these legitimate methods for carrying on business. The paper cites the example of the married doctor or barrister putting the matrimonial home in the name of their spouse in case he or she becomes liable to pay damages in respect of their professional actions. Accountants have adopted similar measures for as long as the medical profession.

3.3 The holding of the family home and retirement assets in the name of the spouse has provided the security demanded for accounting practitioners to undertake the business risks associated with conducting a practice that is subject to claim in tort for negligence. The purpose of these legitimate arrangements has been to protect family assets and importantly to provide a framework in which businesses and partnerships can develop and professional services are provided. If the personal assets of the professional are no longer secure from litigation, the number of persons willing to continue to provide professional services will significantly reduce.

3.4 It should be remembered it is not just the 'privileged and wealthy' that employ these legitimate asset protection structures. In today's litigious climate, many staff of accounting practices providing audit services, from an early period in their careers, ensure that the family home is held in the name of their spouse or entity structure.

3.5 Australian Bureau of Statistics figures released on 28 May 2003 identified that two thirds of Australia's 9860 accounting practices have only one principal or proprietor. These practices accounted for 18.6% of total income of $7.7 billion earned by the accounting profession. Although the sole practitioner represents a large proportion of accountants in practice, the income generated is significantly less than those operating in large partnerships and therefore the potential loss to the Revenue of any sole practitioner utilising a bankruptcy arrangement to evade tax is small.

3.7 81.4% of practices are partnerships, with practices with 10 or more principals or partners accounting for more than 48% of total income. The partnership structure is in many respects self-regulating due to the interaction of partners in the operation of the partnership. Each partnership files with the Australian Taxation Office ('ATO') a partnership tax return that provides to the ATO the tax file numbers and partnership incomes of all partners. The ATO therefore has the information it needs to pursue partners who fail to lodge a tax return. If the ATO had been able to identify barristers who had not filed a tax return, the schemes seeking to avoid payment of tax could have been attacked much earlier without substantial exposure to the Revenue.

## 4.0 The threat to commercial transactions

4.1 Aside from the impact on traditional business structures, the proposals will inevitably affect the way in which lenders look at available assets as security. If the assets provided as security were at risk then the cost of finance would rise. All members of the community will feel the potential increase in interest costs with a detrimental impact on economic activity. Furthermore, the increased interest cost to accounting practices in particular would be a tax-deductible amount. It is probable that the proposals designed to reduce tax leakage from professionals could have a negative impact on Revenue collections as the loss to the Revenue arising from increased interest costs of businesses will outweigh the additional tax collected from bankrupts.

**5.0 The principles behind family law are different to those in a commercial context.**

5.1 When a business decides to offer credit in a commercial context the customer decides whether they are willing to take on the risk of conducting business with that person. They assess the risk according to the 'business assets' held by that person and unless specifically offered as security, do not look through to the assets of a spouse or family structure. Accordingly, the laws relating to bankruptcy have been framed recognising that a creditor should not be able to access such assets. We note and support the comments made in the submission by the Victorian Bar – that the spirit and purpose of the Bankruptcy Act and the Family Law Act are quite different. Under family law the spouse has always had an interest in all the assets of a marriage and so are capable of division. In commerce the creditor should only be able to access the 'business assets' that were relied upon when the creditor entered into the transaction. Clearly the ATO do not have a choice to contract with a taxpayer and therefore cannot select with whom they wish to deal. However the solution proposed of giving them rights equivalent to that in Family Law is untenable and inappropriate as it changes the basis upon which commercial transactions traditionally have been undertaken.

**6.0 The adequacy of current law and policy**

6.1. The Bankruptcy Act already provides that any disposition of property by a bankrupt with the intention to defeat creditors is liable to be set aside. The task force is concerned that the existing bankruptcy laws are inadequate because the trustee of the bankrupt is required to establish a fraudulent intent on the part of the bankrupt that can be difficult to prove, particularly in relation to transfers that took place many years previously. These concerns could be overcome by reversing the onus of proof to have the bankrupt to be required to prove that the bankrupt did not dispose of the property for the purposes of defrauding their creditors.

6.2 It is submitted that the remedies available under current law and the policies instituted by the ATO since the discovery of the bankruptcy tax evasion rorts are sufficient protection against future Revenue losses. Given the wide and extensive powers of the ATO and adequate policing of the taxpayer base these unacceptable tax evasion activities can be eradicated without the need to resort to amending the Bankruptcy laws in the manner proposed.

**7.0 Conclusion**

7.1 The professional bodies condemn the use of bankruptcy to avoid payment of tax. However we are concerned that the response to the wrongdoing of a comparatively small number of taxpayers – traditionally from a particular sector of the professions– will have a disproportional impact on all professionals, their families, and traditional commercial structures and arrangements.

7.2 We thank you for accepting this late submission. As this issue is of great concern to our members we wish to be included in the consultative process if it proceeds further. If you wish to discuss this submission or seek further information please contact Alison MacDonald, Manager Business & Practice Support at the ICAA, in the first instance (02 9290 5704 or Alison@icaa.org.au).

**Annexure 1**

## The Institute of Chartered Accountants in Australia - Professional Regulation - Bankruptcy

The Royal Charter granted to the Institute of Chartered Accountants in Australia (ICAA) contains as one of its Principal Objects: " to prescribe disciplinary procedures and sanctions, to exercise disciplinary powers and to impose sanctions for the better observance of the standards of practice and professional conduct of the Institute."

Bylaw 40 sets out a list of events that shall cause a member to be liable to disciplinary action. Of these, 40 (h) states: "if, in the case of a member, affiliate, or registered graduate he has become a bankrupt or has signed an authority authorising a registered trustee to call a meeting of his creditors and to take over control of his property or has authorised a solicitor to call a meeting of his creditors or has executed a deed of assignment or a deed of arrangement or a composition has been accepted by his creditors."

Disciplinary action may include one or more of the sanctions for a member, set out in Bylaw 45 (g) (i):

(1) exclusion from membership;

(2) suspension from membership of the Institute for any period not exceeding five years with eligibility for re-instatement to membership on such terms and conditions as the Disciplinary Committee may prescribe and on producing satisfactory evidence that during the period of suspension he has maintained his professional competence as required from time to time by the Regulations;

(3) cancellation of certificate of public practice;

(4) a declaration that the member is ineligible for a certificate of public practice for a period not exceeding five years and on such terms and conditions as to the earlier termination of such period of ineligibility as the Disciplinary Committee may prescribe;

(5) a fine of an amount not exceeding $100,000;

(6) a severe reprimand;

(7) a reprimand;

(8) a direction that the member obtain such advice relating to the conduct of his practice as the Disciplinary Committee may prescribe;

(9) a direction that the member attend such continuing professional education course or courses as the Disciplinary Committee may specify;

(10) direction for payment of all or any portion of the costs and expenses incurred by the Institute in dealing with the Notice of Disciplinary Action.