15 June 2004

Attention: Gillian Gould
Secretary
House of Representatives Standing Committee on Legal Affairs
R1-109
Parliament House
CANBERRA ACT 2600

Dear Ms Gould,

Re: Exposure Draft Legislation
Proposed Amendments to Bankruptcy Act 1966

Thank you for the opportunity of making a submission in regard to the proposed changes to the Bankruptcy Act 1966, as contained in the Exposure Draft amendments released recently.

We are a Melbourne based Chartered Accountancy firm and act for a large number of small to medium enterprises ("SME's") that are potentially impacted by the proposed legislation. In short, we have grave concerns in relation to the changes proposed and the purpose of this letter is to outline these concerns, followed by our suggestions as to how the intention underlying the proposed measures might be more appropriately dealt with.

We urge your Committee to give serious consideration to the issues raised, as we are fearful that the proposed amendments in their current form will have a serious detrimental effect on the business community that extends far beyond the mischief that (we understand) they are intended to address.

Major Concerns

The Committee is requested to carefully consider the following concerns:

(a) Income Tax v Bankruptcy

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As we understand it, the proposed changes were primarily driven by circumstances where income tax was blatantly avoided by practising NSW barristers. We are very concerned that (for reasons that will be explained below) the far reaching and potentially retrospective impact of the proposed measures is inappropriate, both, of itself, and having regard to the issues sought to be addressed. It is submitted that a better solution would be to examine ways this could or should have been addressed under legislation relating to income tax, rather than the imposition of a draconian set of general bankruptcy provisions.

(b) Known Liability v Potential Business Claim:

The historic circumstances relating to the NSW barristers that sought to avoid income tax concerned the avoidance of a <u>known liability</u>, namely the liability to income tax. The Federal Government should be fully supported in seeking legislative measures to deal with cases such as these and the business community would fully support this. However, in our view, the avoidance of a known liability such as income tax is quite a different set of circumstances to unforseen liabilities and claims that can arise in a business "meltdown" situation, despite the best endeavours of honest business proprietors and directors. The financial risks associated with undertaking a company directorship and/or proprietorship of a business are already considerable. When one fully considers the open-ended retrospective impact of the proposed measures on assets held by family members and entities, it is evident that what is proposed is an impossible situation for business and professional people. Without fear of overstatement, once the impact of these measures are fully understood, we are genuinely concerned that it will drive people to withdraw from business and commercial activities so as to not be exposed to the attendant financial risks.

(c) Retrospectivity

With respect, retrospective legislation is effectively an admission of failure by the regulators to efficiently carry out their charter. In the taxation arena, a precedent (fortunately one of only very few) was set in the early 1980's, with the introduction of a set of very tough anti avoidance rules. The problems with retrospective legislation are readily apparent – compliance with existing law affords no protection against retrospective legislation.
Although unpalatable (and soundly criticised) at the time, this set of rules at least merely applied a retrospective tax on **<u>income</u>** at a rate no greater than the then maximum personal tax rate. The proposed Exposure Draft is potentially even more draconian; the proposed amendments can apply to unwind normal family dealings without time limit and have the potential to seize 100% of **<u>family assets</u>**.

The proposed exemption afforded by the Exposure Draft (section 139AFB exempt full-value transfer of property), that excludes from the above transfers of property for full market value more than 10 years prior to the event of bankruptcy is, in our view, far too limited. In addition, with the effluxion of time, the burden to prove that the transfer took place at the then market value will be extremely difficult.

(d) Removal of limited liability

These proposals have the potential to remove the generally accepted benefits of limited liability and the generally accepted principle that one should not put family assets at risk in business. Limited liability is the cornerstone of private enterprise and, without its protection, individuals will simply refuse to assume business risk. The proposals effectively afford potential claimants the ability to track through corporate entities and seek to recover from the shareholders funds that in some way can be regarded as falling within the definition of tainted property of the bankrupt. The proposed legislation is very complex and provides a vast array of tracing powers including where subject property or moneys are converted or disposed of. In addition there is proposed a very broadly defined anti avoidance mechanism (Section 139AM) that replicates tainted purpose and tainted property to related third party entities. As a result are there numerous scenarios whereby owners of property derived by virtue of shareholding of shares in proprietary companies could give rise to a liability to pay moneys to a bankrupt's estate.

The following is just one example where the corporate veil can be lifted and innocent third parties can be exposed to the individual liabilities of a bankrupt:

> There is a provision to impute an arm's length remuneration for past services the bankrupt has provided to related entities (section 139AL). If the actual remuneration is less than the imputed reward, then the difference aggregated over an unlimited past period is then potentially claimable back from the entity. Assume that a director of a private company becomes bankrupt from a transaction unrelated to the activities of the family company. The claimant contends that the bankrupt was insufficiently remunerated by the family company for services rendered over the past 30 years. A claim is made on the company for notional earnings of the bankrupt (which, incidentally, can evidently be made under the proposed legislation on a pre-tax basis). The company may have consistently passed dividends on to shareholders over the same time period. The dividend policy may, in part, have been driven by the desire to keep the business assets to minimum. Again remember in this illustration the reason for bankruptcy of the individual was not related to the services the bankrupt provided to the company. Notwithstanding the above under the proposals the company and even the shareholders of the company may be at risk of having to make a contribution to the estate of the bankrupt.

(e) Burden of proof

Instead of requiring third parties to prove some form of mischief, the bankrupt is presumed guilty and has to explain (with evidential support) transactions tracking back possibly decades, (refer proposed section 139AFA). This is in contrast to the requirement under the income tax law and Corporations Law to keep appropriate books and records only for a finite period.

(f) Loaded Gun in the hands of an aggressive third party litigant

The proposed changes do not merely represent a compliance or anti avoidance tool to be used by regulator (for example the Australian Taxation Office) but also provide a commercial tool to a potential aggressive litigant. If enacted, it is likely that these changes would be used as a threat to effectively extort funds from related third parties. The third parties may well, in many cases, acquiesce simply to avoid a long and protracted legal battle.

(g) More urgent changes required

As a related concern, we draw your attention to the recent South Australian Supreme Court decision in Hanel v O'Neill (2003). This decision is of great concern and requires immediate attention or clarification. Coupled with the proposed bankruptcy provisions, this case has enormous implications not only for SME's conducting their businesses through trusts (and more specifically the directors of the relevant trustee) but, in addition, the funds management industry

Submissions

Your Committee is respectfully requested to examine or consider the following:

(a) Existing Measures

If (as we understand to be the case) the main mischief which gave rise to these proposals was the deliberate failure to lodge income tax returns coupled with transactions designed to impede the collection of readily ascertainable tax liabilities, then could an examination be undertaken as to what existing penalties existed and whether or not they were sought to be applied? It is noted that the existing penalties for the recurrent failure to furnish income tax returns can result in imprisonment. In addition there are provisions under the Crimes Act that could have been (and indeed may have been) considered. Presumably these matters were referred to the relevant Director of Public Prosecutions for consideration? The demonstrable application of the existing law particularly imprisonment, would be a strong deterrent not to flout the taxation laws.

(b) If existing taxation laws have been found to be inadequate, then consideration should be given to the following, as an alternative to the proposed legislation:

- A prohibition on practising in the profession in which one became bankrupt whilst a person remains an undischarged bankrupt.

- Amending Income Tax legislation enabling the assessment to raised to persons who have received the benefit of the income determined by similar tracing provisions to that proposed but restricted to known taxation liabilities at the time of bankruptcy.

(c) Removal of retrospective aspect to the law.

To the extent that the broader proposals are enacted, it is then submitted they should only have application to transactions arising after the date of Royal Assent. In this way, individuals made bankrupt after the date of Royal Assent would have examinable transactions on a composite of rules of both the existing and the new legislation, determined by the date of the transaction. This is certainly more equitable to the current proposal which attributes a mischief to a transaction that may have occurred as long as (say) 30 years ago which, at the time, was regarded as not only prudent but the generally accepted norm. Advisers would have been held negligent to advise other than on this basis.

(d) Allow as acceptable (as a non-tainted purpose) all transactions that predate any liability claim by 10 years, notwithstanding the purpose of the transaction. This provides a degree of certainty and practicality as well as overcoming the need to maintain records for more than 10 years. To maintain the integrity of the 10 year period, it is suggested that the 10 years relate to the date of the relevant claim, not the date of bankruptcy.

(e) To overcome the decision in Hanel v O'Neill, amend section 197 of the Corporations Law to ensure its application is restricted to circumstances where the trustee has exceeded its powers in relation to a right of indemnity.

Impact of proposals

The proposed changes will have a widespread impact on the business community far beyond what might be intended or realised. It will affect:

- All small business proprietors, (i.e. all unincorporated sole traders and partnerships). This would number in the hundred of thousands.

- All professional advisers who are prohibited by law to incorporate. Unfortunately the current liability position in many States is open ended with no capping and 100% insurance cover is impossible. In addition professional advisory firms are often of a substantial size and the liability of partners is both unlimited and joint and several. Accordingly the bankruptcy of a partner may be brought about through a negligence claim in regard to an event to which they were never personally involved. This is the environment they currently operate under and to persecute them further through the proposed bankruptcy changes is intolerable.

- All company directors or officers who may be personally liable through negligence, personal guarantees, via operation of Corporations Law, etc.

- All persons affected by what is somewhat colloquially referred to as "sexually transmitted debt"; that its debts incurred by a spouse. Under these proposals, this risk has increased manifold, as the spouse may not even be aware of the liabilities incurred by their spouse, yet may be subject to a claim in relation to property they thought was rightfully theirs.

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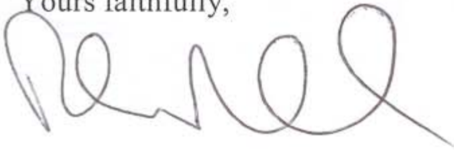
It is submitted that failure to address the above will place an unacceptable financial risk/burden on the business/professional community. It will make financially successful people less willing to undertake business/professional activities for fear of placing their family's assets at risk of potential third party claims.

Many potentially affected people currently have little knowledge at this stage of the proposals, as somewhat surprisingly it has received little press. However, SME proprietors, professional advisers and company directors will soon realise its implications and our expectation is that the reaction will be both negative and considerable.

Yours faithfully,



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Encl.