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BANKRUPTCY LEGISLATION AMENDMENT (ANTI AVOIDANCE & OTHER MEASURES) BILL 2004

BY Gillian James

The notes below have been put together from a series of papers and submissions and have been done at very short notice (2 hours). Given a few days a full and proper briefing can be done.

The key issues to keep in mind are as per the bullet points below, some of these are also addressed in detail below.

The proposed legislation is poorly drafted and will create considerable uncertainty both now and into the future about arrangements that business people, not just professionals have in place for their assets structuring.

Many arrangements that are in place were done for taxation purposes within the tax act and are not illegal. For example rental loss property structures that took place 10 to 20 years ago as being the prime reason for assets being kept separate.

The Prime Minister has made a statement in relation to superannuation recovery provisions of the Bankruptcy Act that are now to be passed in separate legislation as follows

Monday 16 February, 2004 and as reported in Hansard at 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 this government's policy not to embark on retrospective legislation such as that set out in the Bill.

Key Points (Not in any order of importance)

- Retrospective Legislation
- Will apply to transactions that took place 20 years ago or more.
- Onus of burden of proof is placed on Bankrupt or targeted entity to refute the claim. Records for such a claim will in most cases go back prior to 7 years period of requirement to keep financial records
- Will have financial implications – Bill Explanatory Memorandum says none
- No phasing in of legislation at a specific date as is usually done
- Social consequences long term for people who lose everything
- Heavy reliance on Court intervention that will cause further backlogs in Court proceedings, as well as additional cost
- No safeguards for existing legally operating structures
- Deterrent to small business taking risks in the future
- Financial loss on tax not recovered to date only \$20m – Social Security payments and other costs are likely to well exceed this in the long term
- Not supported by professional bodies IPAA, ICA, Master Builders Association, Law Council of Australia
- Little understanding by general public or business people of long term implications.

- Insurance is not available for all industries to cover all risks, or if it is, then it cannot be obtained at reasonable cost.
- Failures of insurance companies have taken place and left people both professional and small business with liabilities that were not covered – for example HIH and other schemes which did not cover all claims.
- Prime Minister has made a statement that he does not approve of retrospective legislation (16 February 2004)
- Limited if any input into drafting of legislation by business groups
- Bill should have been confined to tax debts, which was the brief of the Task Force that reported in 2003, whereas proposed legislation applies to all bankrupts past and future regardless of how bankruptcy incurred
- Bankruptcy is to also rehabilitate debtors, not make them and their families destitute.
- Unfavourable press commentary to date – Bulletin, Financial Review
- Problem with the NSW Barristers is now rectified as NSW Bar Society has apparently changed their practice rules prohibiting Barristers practicing if they are bankrupt.
- Legislation does not take into account “no fault” bankruptcies. For example a tour operator being caught by SARS and cancellation of all his or her business.
- Overseas Bankruptcy Acts do not have these types of provisions
- Off shore investors who become non executive directors to monitor investments may decide not to invest in this country
- Local companies may decide to operate manufacturing operations off shore where risks are less (One example of this has already been advised). Thus there will be loss of jobs and growth in the economy
- Legislation should be revised to be specific for rorts for tax evasion, probably along similar lines, but with certain specified pre conditions and specified periods over which a trustee can “go back” linked to the length of the tax debt plus a margin of up to 2 years.

I believe you should undertake further research on this (I am happy to brief you if required).

From a political aspect why the Government has introduced this legislation in an election year defies imagination, as it is unlikely to be popular with the electorate once everyone realises the likely implications.

Recently (Early May 2004) The Attorney General released a draft of the above proposed legislation.

I have reviewed the draft legislation along with others specialising in this area, and most comment that the existing legislation is poorly drafted and difficult to interpret, however a summary (prepared by a major legal firm) is as follows.

The Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004 (Cth) (the **Bill**) seeks to implement recommendations made in January 2002 by the *Joint Taskforce Report on the Use of Bankruptcy and Family Law Schemes to Avoid Payment of Tax*.

The proposed amendments are a response to the public outcry about barristers and company directors who have been declared bankrupt with large outstanding debts, but continue to live the 'high life', funded by assets held by their spouses or family trusts, and therefore protected from creditors. The Attorney-General initially announced the changes on 16 December 2003, and on 14 May 2004 an exposure draft of the Bill and Explanatory Memorandum was released.

Orders for recovery of property from third parties

The proposed amendments aim to prevent high-income earners from shielding their 'real assets' from creditors when they become bankrupt. This will be achieved by allowing the courts to make orders for recovery of 'tainted property' and 'tainted money' held by third parties (including the bankrupt's spouse or family trust).

Property held by a third party would be 'tainted property', and therefore recoverable, where:

- the property was acquired by the third party:
 - using funds or property provided by the bankrupt prior to bankruptcy;
 - by a transfer from the bankrupt prior to bankruptcy;
 - as a result of personal services supplied by the bankrupt to, or on behalf of, the third party; or
 - as a result of a scheme; and
- the bankrupt's main purpose in making the transfer was to ensure that the funds or property would not be available to pay creditors (a 'tainted purpose'); and
- the bankrupt has used or derived a benefit from the property now held by the third party (including any replacement property that can be traced to the original transfer).

Money held by a third party would be 'tainted money', and therefore recoverable, where:

- prior to the date of bankruptcy the money was transferred by the bankrupt to the third party, and the bankrupt had a 'tainted purpose' in paying the money; or
- the money was the proceeds from the disposal of tainted property.

In addition to extending the circumstances under which property can be recovered from third parties, the amendments also create a presumption that the bankrupt had a 'tainted purpose'

if the trustee of the bankrupt's estate alleges that they did. This makes it far easier for trustees to challenge transfers than under the existing legislation, because the burden of showing that the transfer was for a legitimate purpose is placed on the bankrupt.

Property that cannot be recovered

The court would not be able to order recovery of property held by a third party where the third party provided market-value consideration in return for the original transfer, and either:

- the transfer occurred more than 10 years before bankruptcy; or
- the transferee was unaware of the bankrupt's purpose in making the transfer.

Other amendments

The proposed amendments also:

- improve the ability of trustees in bankruptcy to collect income contributions from bankrupts; and
- allow trustees in bankruptcy to challenge transfers by the bankrupt in a financial agreement made under Part VIII A of the *Family Law Act 1975* (Cth).

Implications

The proposed amendments will apply to all bankruptcies current at the date the Bill receives the Governor's assent, and any bankruptcies occurring after that date. The amendments therefore apply to all previous transfers made by the bankrupt, including those carried out long before the amendments commence, in circumstances where the transfer was lawful at the time it was effected. This retrospective legislation obviously will affect more than just high-income earners.

These amendments significantly extend the circumstances in which trustees in bankruptcy can recover property from third parties, and will certainly improve creditors' access to the 'real assets' of the bankrupt. However, the amendments will jeopardise the sort of family arrangements that are currently very common among professionals and company directors. Indeed, the explanatory memorandum notes: 'the amendments... represent a fundamental shift away from the perceived legitimacy of these arrangements'.

The task force was formed following the identification of the actions of approximately 56 barristers in NSW who have rorted the tax system, using bankruptcy to avoid paying tax, and alienating their real assets in related entities that cannot be accessed currently by a trustee in bankruptcy.

I along with most other insolvency practitioners support any legislation that stops people to deliberately diverting assets and income to avoid their taxation and other responsibilities.

The emphasis should have been to deter people who deliberately avoided paying their debts and matching those "related assets" to the period of the debts.

It was assumed that the task force would focus on fraudulent activities of a small number of tax payers and recommend legislation that allowed trustees to access these assets which had been deliberately alienated.

The resulting legislation that is proposed effectively allows a trustee to access to assets held in related entities for any bankrupt and there is no time period limits over which he can go back..

This Bill should have provided specified time periods over which trustees could access related assets, but linked to the period of debts incurred plus an additional period similar to other relation back transactions set out in the bankruptcy act.

The Attorney general seems to be focussing on professionals, and has said people should insure against negligence claim but he has failed to consider that outside of the professional group there are tens of thousands of people who cannot insure their risks.

There are also significant numbers of small business people who have “no fault bankruptcies” Additionally most of these people earn average incomes and would not be considered “high income earning professionals”

Examples of this are small businesses that trade through a legal tax structure such as a company or trust and are involved as a sub contractor or supplier on larger projects. Typically they are an employer however would probably employ less that 20 people, however this will vary. Their major asset is usually their family home and they legally have held this in their spouses name or in a related entity. In the event of a failure most of the business assets will be lost.

Bankruptcy usually results from personal guarantees given, which in most cases the individuals cannot pay from their own resources.

As they cannot insure against bad debts or principal contractor failure, most will have taken advice to put their house in their wife’s name, or have assets that have been accumulated from distributions or dividends from their business in another entity.

This structuring is not done by people to deliberately avoid known debts, it is to shelter them from the unexpected in the future.

Thus in most cases are assets that have been legally sheltered over many years and these people will now have those assets seized.

Worse is the fact that the onus of proving the assets should not be seized is placed on the bankrupt a guilty until the defendant proves them selves innocent of the claim, such defence may be difficult if transactions took place over 20 years ago, keeping in mind there is not time limit over which claims have been made.

Small business and risk taking is the back bone of growth in this country/

The effects of this in the long term will be as follows

- A person in business who has a “no fault bankruptcy” such as due to a bad debt or inability to insure is being penalised for trying to protect their assets for their family.

- Single people would get no relief from any seizure orders as they have no other parties to consider for hardship.
- “Long tail“ litigation could be uninsurable for doctors and other essential professional persons who may get sued long after an insolvency event happens and any assets held would be at risk. For example a doctor who is sued 10 plus years after a negligence takes place.
- With recent case law on liabilities for non-executive directors of companies, non-resident directors’ indirect assets would be at risk. This is likely to cause a reduction of investment in this country.
- Professionals and business people who take risks are likely to reduce their exposure to risk, and this will have a direct impact on people wanting to go into business and employ people. This will have a direct impact on employment and GDP over time.
- Banks and other lenders will be forced to take further security to counteract the effect of the legislation, which will reduce returns to unsecured creditors, thus defeating the alleged objective of the proposed legislation.
- People close to retirement who lose assets held in related entities will become a burden on the social security system and medical system, as they will never recover financially or mentally from losing everything.

The proposed legislation is a knee jerk reaction to approximately 56 rogue professionals and others with tax estimated in the task force report at approx \$20m and this was over a number of years. The amounts involved are small and will be offset by losses in other areas in the future.

Whilst you may think that all people should pay all their debts and be left with nothing, the reality of this is this does not work. I am not an expert on Bankruptcy systems world wide, however my understanding is that in most other first world countries legislation such as this has not been enacted.

I understand the institute of Chartered Accountants of Australia and the Insolvency Practitioners association of Australia (IPAA) is opposing this legislation however I have not seen their submission.

The difficult part is to have legislation that seeks a balance between preserving the existing status quo which allows some alienation of assets, and those people who deliberately set themselves up to go bankrupt and avoid their obligations.

What ever happens with the legislation there needs to be

- A restriction of time periods that a trustee can go back to recover assets in related entities
- A removal of the “guilty until proved innocent” clauses of the Bill
- A restriction on the types of activities that apply to recoveries

This Bill is poorly drafted and the Courts will have considerable difficulty interpreting what assets are to be recovered.

Little consultation of business was taken in the drafting and it has been written from the perspective of people who have never taken risks in business.

My big concern is not for business professionals who as Mr Ruddock says should be insured, but for people in risk areas such as medicine and other health care areas. Experience has shown that insurance has not solved the litigation problem as two of the major insurers the medical scheme and HIH have failed leaving in their wake a range of people who were left without cover.

For further technical information please telephone

*Tony Douglas-Brown
Bentleys MRI Perth*

08 9480 2000

tdouglasbrown@pert.bentleys.com.au