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29 June 2004

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

Dear Sir / Madam,

Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004

I have recently reviewed a copy of the above Bill and have a number of concerns.

I originally believed the Bill would be targeted at tax evaders who had transferred assets to related entities and declared bankruptcy so as to get rid of their tax debts when they were caught.

However, the Bill goes much further and is likely to operate very unjustly and will be a significant disincentive for people to become or remain in business.

Breadth of the legislation

As you may be aware, the legislation allows a trustee in bankruptcy to call back "tainted property" which had been transferred by a bankrupt to another entity for less than market value consideration.

Tainted property is defined as (among other things) where the bankrupt's main purpose in making the payment or transfer was to prevent money from becoming divisible among the bankrupt's creditors or to hinder or delay the process of dividing this money between creditors.

There are many instances where people have undertaken asset protection planning to transfer assets to a spouse at lower risk at being sued. Objectively, these transfers will fail this main purpose test and the property transferred can be clawed back by the trustee in bankruptcy at any time in the future. There is no time limit set out in the Bill.

The current bankruptcy legislation sets out a more balanced approach. If a transferor is insolvent at the time a transfer is made, the trustee in bankruptcy can claw the property back at any time in the 5 years after the transfer. If the transferor is solvent at the time of the transfer, the trustee only has 2 years from the date of the transfer to do this. The current legislation strikes a balance between allowing the trustee to claw back transfers which have probably been made in contemplation of an impending bankruptcy, but does not extend this clawback to assets which have been transferred years or decades before the transferor's bankruptcy.

Retrospective operation

The legislation effectively operates with retrospective effect. Whilst it only applies to bankruptcies which occur after the date of enactment, it will apply to all property, money or services transferred, even if these transfers occurred before the date of commencement. Accordingly, the Bill would render useless the efforts of individuals who, whilst solvent, had prudently organised their affairs (often with adverse income tax, capital gains tax and stamp duty consequences) to minimise the risk of all their personal assets being seized by an unexpected event of bankruptcy. These individuals made these decisions based on the bankruptcy laws in place at the time, but this new Bill would potentially place all of their assets at risk of seizure.

For example, a doctor may have transferred the family home to his wife 30 years ago to protect it from creditors if he went bankrupt. His wife had a full-time (unpaid) job of raising their children, caring for her husband and keeping their home in order. The doctor retires today. Five years later, he is sued for something an employee did and the insurance company refuses to pay out because the events giving rise to the lawsuit are excluded from its policy.

The doctor then goes bankrupt.

Under the new Bill, everything he and his wife (and possibly their children) own can be seized by the trustee in bankruptcy. The Federal Court can order their home to be sold and the proceeds paid to the trustee in bankruptcy. Before the court can do so, it must consider whether the wife should get a share of the proceeds due to her non-financial contributions but only to the extent that these contributions are reflected in the house's market value. Thus, if the wife added a built a new storey to the house or made capital improvements to it, she can get a share in the proceeds. The court cannot take into account the hardship the sale would cause the wife or the children but must take into account the hardship (if any) such a sale would cause the wife's creditors! (discussed further below).

Reverse onus of proof

One of the unjust aspects of the new Bill is that it allows the trustee in bankruptcy to claim that any property owned by a non-bankrupt entity is a tainted asset (section 139AFA(6)). It is then up to the property-owning entity to prove that it is not or that full market value consideration had been paid for the property. If the property had been transferred decades ago and no records exist of the consideration paid for the property, it would be almost impossible for such an entity to prove its case.

Impact on 'innocent' bankrupts

Not everyone who becomes bankrupt is necessarily a fraud or a cheat. Sometimes, people become bankrupt due to factors beyond their reasonable control e.g. a business which fails following a breach of contract by a large supplier or customer, or a doctor who recently joins a medical partnership and is held jointly and severally liable for an act of negligence performed by an employee doctor 5 years ago.

Yet, these people would face effectively the same penalty as bankrupts who had fraudulently amassed wealth at the expense of creditors. An unscrupulous bankrupt is also more likely to remit this wealth offshore to a tax haven and refuse to disclose these assets in his Statement of Affairs. The new Bill will not stop such an unscrupulous bankrupt from being able to do these things, and will not make it any less likely that these people would get away with their fraud.

Impact on innocent purchasers

The Bill looks only at the bankrupt's intent, not that of the transferee. Exemption for full-market value transfers in section 139AFB only applies where the transferee gives consideration "at least as valuable as the market value of the property".

So, if a bankrupt realises creditors are closing in, he could conduct a "fire sale" of his assets for slightly less than their market value to innocent unrelated parties. These parties would have no knowledge of the bankrupt's state of mind or purpose in making the sales. They would simply think they were getting a bargain until they receive a demand for these assets from the trustee in bankruptcy.

Even if the transferee pays 85% or 90% of the market value of the property, section 139AFB(1)(a) will ensure the full market value exemption does not apply, and the trustee in bankruptcy could claw back this property.

The Bill would overturn a well-established principle of law that assets cannot be clawed back from a bona fide unrelated purchaser for value.

This Bill would add significant uncertainty to very normal commercial transactions, would operate unjustly towards innocent purchasers and undermine basic contract law and property rights.

Impact on families

The Bill would have a significant adverse impact on families of bankrupts. The non-bankrupt spouse would stand to lose everything s/he owns unless s/he can prove s/he paid full market value for it and that the money came from him/her and not the bankrupt spouse. This may sound harsh, but this is the combined effect of sections 139AFA (particularly 139AFA(6)), 139AI, 139AJ, and 139F.

Bias against single income families

Despite the increased family assistance offered by the recent Federal Budget, the Bill unfairly discriminates against single income families. If the income-earning spouse becomes bankrupt, such families will have a very hard time trying to justify why the non-bankrupt spouse should be allowed to keep any assets. The Bill is aimed at benefiting double-income families, where the non-bankrupt spouse may be able to show evidence that s/he had paid all the mortgage payments for the family home out of his/her own salary (and take advantage of the market value exemption under section 139AFB).

A single-income family is likely to have no such defence. The non-bankrupt spouse will have to rely on the Court's mercy and hope the Court will consider the hardship caused to him/her under section 139F(1)(a) of the Bill. However, the Court will be unable to use that section to consider the hardship posed to children of the couple since these children will not have any "estate or interest" in the family home or other assets of the couple. So, whilst section 139F(1)(b) will allow the Court to consider the hardship caused to the non-bankrupt spouse's creditors, the Court cannot take into account hardship caused to children of the couple. Section 139F(1) makes it clear that the Court "must not take account of any other matters". I cannot see why this prohibition has been inserted into section 139F(1). If there are any other important matters (such as hardship to children) which a Court should consider, surely this should be added as a 9th factor?

If the non-bankrupt spouse has stayed at home to care for the couple's children and keep and maintain their home, this non-financial contribution will have to be ignored by the Court. The Court is only allowed (under section 139F(1)(bb)) to consider such non-financial contributions only to the extent to which "the market value of the property reflects" this contribution. So, if the non-bankrupt spouse was a handyman and added an extra storey onto the house or added an extension (using his/her own labour), then this could be taken into account by the Court, but not otherwise. This result is quite clearly unfair.

Can insurance solve the problem?

It is (even under the current Bankruptcy Law) good and prudent practice for people (especially businessmen) to insure themselves adequately against any foreseeable risk which may lead to bankruptcy.

The problem is that sometimes, these risks are not very foreseeable or easily predictable (such as the example of a new partner in a medical practice who finds himself liable for things he had nothing to do with).

The other problem (which is fast becoming a significant one) is that insurance policies are increasingly containing a greater number of exclusions. Most policies now exclude acts of terrorism (even though an ordinary person can usually do nothing to prevent a terrorist attack). They also exclude a whole range of other circumstances.

Even where an insured has grounds for a claim, insurance companies are now more likely to refuse to pay out the claim and hope the insured's relatively meager resources will preclude a court challenge.

In the current insurance market with its broad exclusions, it is increasingly likely that ordinary people will be left to bear significant liabilities through no fault of their own despite having believed they held adequate insurance cover.

Interaction between Family Law and Bankruptcy Law

The Second Schedule of the proposed Bill seems to be quite appropriate. The provisions allowing the trustee in bankruptcy to effectly step into the shoes of a bankrupt spouse in property settlement negotiations will prevent bankrupts from being able to continue to use unfair Family Court settlements as a mechanism to remove most of the bankrupt's assets out of the reach of creditors.

However, the Bill does this without removing the Court's powers to consider the maintenance needs of the non-bankrupt spouse or the interests of the children of the couple. For example, the new section 72(2) will allow the Family Court to order transfer of vested bankruptcy property to the non-bankrupt spouse to fully or partially satisfy any maintenance claim. Proposed section 79(1)(d) allows the Family Court to make orders requiring the relevant bankruptcy trustee to make "for the benefit of ... a child to the marriage", such transfer of property as the court determines.

The Family Court thus has the express power to take into account the needs for maintenance of the non-bankrupt spouse and the children of the marriage. These are powers the Federal Court does not have in dealing with a normal bankruptcy application. The Federal Court must only look at the specific factors listed in section 139F(1) (as discussed above). It cannot take into account the hardship which would be suffered by the non-bankrupt spouse or children if property (such as the family home) is sold up.

Under this Bill, a couple and their children would be better off if they separated or divorced when bankruptcy became imminent.

Promotion of Tax Evasion

The Bill appears to be so water-tight that there are very few ways to legally protect one's assets from creditors in the event of "innocent" bankruptcy. This will increase the attractiveness of the various illegal ways to achieve this aim. It is likely to increase the attractiveness of transferring assets and cash out of Australia into a tax haven jurisdiction or one with a high level of banking secrecy. If a person takes this course of action to protect their assets from any potential creditors which may or may not arise in the future, the person will have a strong incentive to also engage in tax evasion. There would be little point in shifting one's assets offshore if the income from these assets are disclosed in one's tax returns over the years.

The Bill (if enacted) will drive many people into hiding assets offshore as an asset protection strategy. To ensure this strategy is effective, they will have to engage in tax evasion. As our tax system is one based on self-assessment (with very little audit activity by the ATO), I suggest that the Bill is likely to trigger increased levels and amounts of tax evasion to the detriment of the revenue.

Conclusion

The changes will place at risk the assets of anyone who goes bankrupt for whatever reason, even people who have been scrupulous in their tax affairs, but who have become bankrupt through factors beyond their control. When the electors realise that these draconian laws could apply to take away every item of property they had worked so hard to accumulate, they may well view the Bill in a different light.

For the property rights of all Australians, I would strongly urge the Committee withdraw the tainted property provisions (Schedule 1 of the proposed Bill) or restrict its operation only to the recovery of tax debts owed to the Commonwealth.

The current bankruptcy legislation does operate to allow a clawback of assets transferred by a bankrupt between 2 to 5 years before bankruptcy and strikes a good balance between punishing unscrupulous bankrupts and preserving general property rights.

If you have any queries or would like to discuss this matter further, please do not hesitate to contact us.

Yours sincerely,

Suryan Chandrasegaran