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

17 June 2004

Dear Ms Gould

Inquiry into the *Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004*

We refer to your letter of 2 June 2004 to Mr Paul Cook inviting a submission from the Insolvency Practitioners Association of Australia ("IPAA") in relation to the *Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004* ("the Bill"). We appreciate this opportunity.

The IPAA is the leading professional organisation within Australia for specialists practising in corporate and personal insolvency. We welcome any legislative amendments that allow Trustees to draw back any assets for creditors in the event of bankruptcy. However, what we want are amendments that are practical, fair and enforceable.

Our submission principally focuses on the proposed amendments to Division 4A of Part VI of the Bankruptcy Act 1966.

1.0 General overview

When considered as a total package, the amendments will put considerable, and possibly, unreasonable, pressure on Bankruptcy Trustees to implement extensive, and thus expensive, investigations / recovery actions / Court applications. This is of concern, given that many Bankrupt Estates either have no funds or insufficient funds to take these actions and creditor funding is generally not provided. Accordingly, in our opinion, Section 19 of the Act, being the section that specifies Trustees Duties, should, if the Bill is passed in its current form, insert a specific clause to the effect that a Trustee is only under an obligation to take any action if he/she is reasonably satisfied that there are sufficient funds in the Estate to undertake that action, or that appropriate indemnities can be obtained from creditors.

2.0 Amendments to Division 4A of Part VI of the Bankruptcy Act 1966

2.1 Introduction

The IPAA does not support the regime that fosters or encourages tax cheats. However, there are serious concerns of the proposed amendments as to whether the issues identified in this submission outweigh the benefits. It is our view there are other ways to reduce the incidence of tax cheating.

Although the IPAA has issues with the Bill in its current format, the IPAA supports the policy objective of the Bill set out in the Explanatory Memorandum being "to address the issue of high income professionals using bankruptcy as a means of avoiding their taxation ... obligations". We have limited our support to taxation obligations as this is the issue identified in the Joint Task Force report entitled "The Use of Bankruptcy and Family Law Schemes to Avoid Payments of Tax" which formed the basis of the Bill. It is important to clarify at this point that the Joint Taskforce Report focused on avoidance of tax, whereas the Bill has much broader application than this.

It is also noted that the impetus for changes proposed by the Bill, being a number of NSW solicitors and barristers failing to comply with their tax obligations and using bankruptcy to avoid payment while being able to retain their ability to practice, has been resolved through changes to prevent bankrupt, or previous bankrupt, legal practitioners from holding practicing certificates.

In this submission, we have focused on technical issues and problems that Trustees will encounter in attempting to practically implement the Bill.

2.2 Expectation Gap

It is the IPAA's opinion that the Bill, if passed, will result in an expectation gap for creditors. Creditors will anticipate greater returns from bankrupt estates as a result of these amendments, however, the IPAA suggests that in the majority of cases the returns may actually be reduced due to the fact that Trustees will have to conduct more detailed investigations of the bankrupts' affairs but in the majority of cases there will be no assets to recover or the cost of the investigation and recovery action will exceed the recoveries. As stated in the explanatory memorandum the problem that these amendments are aimed at rectifying occurs in a "small but significant number of high-income debtors" – not in the majority of bankruptcies. It is our opinion that in the majority of bankruptcies, creditors' positions will be adversely affected, even though in occasional cases of abuse there will be a greater dividend.

The implementation of a timeframe, as discussed below, will assist Trustees in managing the costs of investigations as there will be a defined limit to his or her investigation, rather than being required to consider the bankrupt's affairs back to the start of his or her working career.

2.3 Trustees' costs

Trustees are already under enormous pressure from creditors to contain the quantum of their fees. Creditors are generally more interested in receiving a dividend from any monies readily available than spending that money to investigate the bankrupt's affairs and potentially recover more assets. Furthermore, it is unlikely that any bankrupt or third party will give up any identified assets without a vigorous courtroom conflict which will result in higher Trustee and legal fees.

The IPAA queries how Trustees are to comply with the investigatory obligations imposed on them by the amendments, particularly in their current format with no time limit, whilst still complying with the requirements of the Personal Insolvency National Standards which require Trustees to "have regard to the views of creditors as to the extent to which investigations are undertaken in an administration" (PINS 1.4).

In no-fund bankruptcies or bankruptcies with limited funds, creditors are generally reluctant to provide funding to assist the Trustee with his or her investigations. Furthermore, our experience as practitioners is that whilst the Australian Taxation Office ("ATO") does fund some cases from time to time, these cases are very rare. We note that the Government has stated that there are no adverse financial costs to the implementation of this legislation and as such we would expect that there would be no significant increase in Section 305 funding where the Commonwealth, in certain cases, provides some funds for legal advice but not Trustee costs. As such, who will bear the cost of these investigations?

It is quite probable that the existing legislation would allow recovery of assets transferred to defeat creditor claims (either through section 121 or the current Division 4A of Part VI) if Trustees were to be provided with sufficient funds to properly investigate and litigate. We do not see how changing the legislation will resolve the issue of lack of funding, particularly since the Courts will need to decide issues (refer discussion on The Court to take account of certain matters (clauses 77 to 82 of the Explanatory Memorandum) below) and a Supreme Court action costs in the order of $30,000.

2.4 Lack of Timeframes

There are no true timeframes imposed in the legislation.

The purpose of the Bill is to address the issue of high income professionals using bankruptcy as a means of avoiding their taxation and other obligations. The IPAA suggest that the lack of timeframes is more for the benefit of the ATO than for the benefit of non-tax creditors. It is highly unlikely that a non-tax creditor would allow non-payment to continue for a significant period of time without taking action to recover the debt. The IPAA recognises that the ATO is in a different position to most creditors in that it cannot choose who it will deal with. However, the ATO can proactively identify non-complying debtors and take action to recover payment or place those debtors into bankruptcy in a timely manner.

It is our understanding that with the introduction of Australian Business Numbers, Goods and Services Tax and electronic cross checking, that the ability of the ATO to detect non-compliance is far greater.

The ATO needs to proactively manage non-compliance rather than relying on legislation which will allow recovery of assets at any time in the future by a Bankruptcy Trustee. Particularly considering the issues that this submission has identified if the Trustee tries to undertake such recovery action – issues such as lack of funding for recovery actions, identification of assets, offshore assets, uncertainty over interpretation, loopholes etc.

If the ATO proactively managed tax obligations, the unlimited time period would not be required as a debtor would be required to either pay tax or go bankrupt much earlier in the process and thus a set timeframe would be adequate to capture any transfers of assets made to avoid payment of tax.

It is the IPAA's opinion that the lack of timeframes will impose unrealistic obligations on Trustees when investigating a bankrupt's affairs (refer discussion on expectation gaps and Trustee's costs above).

Although proposed section 139AFB purports to implement a timeframe of 10 years, it is not an effective timeframe from a Trustee's perspective.

Proposed section 139AFB will still require a Trustee to look for transfers that occurred more than 10 years before the date of bankruptcy for less than market value. This will not limit the Trustee's obligations in any way.

If the legislation is to be retained essentially in its current format, the IPAA suggests that a timeframe be imposed. This timeframe could be set in a variety of ways, including:

- a strict timeframe of say 10 years – similarly to the timeframes imposed under section 120 Undervalued Transactions and section 122 Avoidance of Preferences; or

- a timeframe that is calculated based on the number of years of tax obligations outstanding in addition to a smaller set timeframe of say 2 years.

Thus, in the second option given above, a bankrupt that has 10 years of outstanding tax returns would have an investigatory period of 12 years. In our opinion, the second method of establishing a timeframe is very appropriate if the purpose of the Bill is to penalise those bankrupts that have not met their tax obligations.

We note that section 121 of the Bankruptcy Act does not have a timeframe in relation to the recovery of transfers to defeat creditors. However, there is an essential difference between the Bill and section 121, as section 121 requires the bankrupt to have been or about to become insolvent whereas a transaction can be "tainted" under the new provisions without insolvency being a factor.

In no way does the IPAA support imposing a limiting timeframe where insolvency is a factor.

2.5 Application of amendments (clauses 88 and 89 of the Explanatory Memorandum)

It is proposed that the amendments will apply to all bankruptcies current on or after its commencement. The explanatory memorandum states that the amendments have a retrospective effect which reflects the policy underlying the amendments.

We have a number of issues in respect of this:

1. The definition of current bankruptcies; and
2. The consequences of retrospectivity on Trustees.

Considering each of those issues in turn:

1. The definition of current bankruptcies

How are "current bankruptcies" to be identified? Are current bankruptcies only to be those bankruptcies where the bankrupt is yet to be discharged, or will it include those where:

- the Trustee has yet to be released under either section 183 or section 184 of the Bankruptcy Act; or
- where notice of finalisation has not yet been given to the Official Receiver in accordance with regulation 8.14.

2. The consequences of retrospectivity on Trustees

Although the IPAA understands the reasoning behind the proposed retrospectivity of the amendments, we are of the opinion that the retrospectivity will have greater consequences to Trustees than that envisaged in the explanatory memorandum.

Some examples of the unintended consequences are:

- At the time of commencement there could be estates where the Trustee has paid the final dividend to creditors but the estate is still current. Will this Trustee be obliged to now investigate the bankrupt's affairs in relation to the amendments? Will the Trustee be required to fund this investigation him or herself? If the Trustee does not conduct such an investigation, will the Trustee be negligent?

- Will Trustees be required to investigate every current bankruptcy to determine if the amendments apply to that estate? Who will fund the cost of this exercise?

2.6 Successful Recovery of Assets

The ability to successfully recover assets under the existing legislation or the Bill is dependent on the successful identification of those assets.

Although the Bill may theoretically expand a Trustee's powers, though whether this is the case will be decided in Court, it has gone no way towards solving the issues of:

- lack of funding for Trustees to undertake investigations and the pressure put on Trustees to not use the monies that are available in an estate (refer discussion above on Trustees' Costs);
- lack of books and records held by the bankrupt to assist with the investigation; and
- the identification and recovery of assets hidden overseas such as Swiss bank accounts.

It is our opinion that the proposed amendments will only encourage strategies to further hide assets making the Trustee's task even more difficult and costly.

2.7 Retention of Books and Records

As noted above, an issue generally confronting Trustees is a lack of books and records maintained by the bankrupt to assist them with their investigation.

Under the tax law, taxpayers are generally only required to retain books and records for a period of five years from the time of lodgement of tax returns.

If a bankrupt has lodged his or her tax returns, we query how the obligation to only retain books and records for five years fits with the proposed obligations of Trustees to investigate the bankrupt's affairs for an unlimited time period?

Furthermore, the presumption that the bankrupt would even retain such records assumes an honest bankrupt.

2.8 Exempt full-value transfer of property (clauses 52 to 55 of the Explanatory Memorandum)

Section 139AFB provides that property that has been transferred at market value without the transferee knowing of the intention, would be exempt. Effectively this excludes sales at market value to related parties as it is unlikely that a related party would not know what the purpose of the sale was.

It seems to us that this section is unfair and arguably discriminates against related parties, particularly families. Our interpretation is that essentially it is okay to sell a property at market value to any party at any time – unless it's a related party. If a property is sold to a related party then this by nature is wrong and has a "tainted purpose". An example of where this would be unfair is where a valuable antique is also of significant sentimental value to the family. To ensure that the item remains within the family, a man sells the item to the family trust for market value though the Trustee (being a family owned company) is effectively aware that the reason for the transfer is because the man is setting up his own legal practice and wants to avoid ever losing the item from the family. The man was not insolvent or likely to become insolvent at the time of the transaction. This transaction would be "tainted" if it occurred within 10 years of bankruptcy, yet the estate has not been disadvantaged because the sale occurred at market value.

We note that section 121 of the Bankruptcy Act provides for the recovery of market value transactions where the transferee knew that the main purpose of the transaction was prevent the property from becoming divisible or to hinder or delay making the property available to creditors. However, as noted above, there is an essential difference between the Bill and section 121, as section 121 requires the bankrupt to have been or about to become insolvent whereas a transaction can be "tainted" under the new provisions without insolvency being a factor.

2.9 The Court to take account of certain matters (clauses 77 to 82 of the Explanatory Memorandum)

Of particular concern is Section 139F, the matters that a Court is to take into account.

Sections 139F(1)(a) and 139F(2)(a) state that a Court must take into account any hardship that an order of the Court might cause that other person or entity. The courts were to be given some discretion in relation to hardship, but nowhere in the explanatory memorandum is hardship defined. In our view there are many definitions of hardship found throughout Commonwealth Acts resulting in a lack of certainty to anyone interpreting the legislation.

Sections 139F(1)(b) and 139F(2)(b) provide that if a claim is made on a respondent entity regard needs to be had for those entity's creditors. There is no notice or comment whether or not those entity's creditors are related parties or non-related parties, nor does that Act suggest that it is public policy for that entity's creditors to be paid first. It is uncertain.

Sections 139F(1)(ba) and 139F(2)(c) state that regard has to be had to the extent to which the market value of the property / money reflects the bankrupt's ultimate contribution (whether financial or non financial). Once again this is a discretionary matter and there is no guidance in the explanatory memorandum.

Sections 139F(1)(bb) and 139F(2)(d) requires regard to be had to the contribution of an entity or person other than the bankrupt. Again there is no guidance.

Section 139F(1)(c) states that regard is to be given to the extent to which a person used or directly or indirectly derived a benefit from the property. Benefit is not defined and if something is aesthetically pleasing to a person does that mean that is a benefit to a person, conversely if a bankrupt dislikes a painting that is owned by his wife, can it be said that he has received a benefit from that painting?

Sections 139F(1)(f) requires consideration of the extent to which the property was available for use by the bankrupt. Once again there is no indication or guidance as to the extent of benefit one gets in determining the ultimate outcome or split of that property.

It is widely acknowledged that there is a time lag of some fifteen years before these matters are ultimately resolved in the High Court. In the meantime, practitioners are asked to adjudicate on these claims and we have concerns that different Trustees will adopt different views on these subjective matters particularly where there is no guidance given in the explanatory memorandum. We do not think it is good for the profession for there to be "manipulated" Trustee shopping to achieve the best result for either debtors or creditors. There ought to be a public policy that all Trustees would act in a similar manner using similar commercial principles. The Act is absent on guidance on these issues.

Further, given that the Court must also take into account both financial and non-financial contributions, it is highly likely that there will be a wide range of conflicting decisions, resulting in significant confusion in the application of these sections.

Finally, this section is constructed such that the Court must not take into account any other matters. However, this begs the question in the circumstance where the value of the "tainted property" or "tainted money" is significantly greater than the amount required to pay out the Bankrupt Estate in full and thereby annul the bankruptcy. Surely, this is a matter that the Court should take into account prior to making an Order. It would be inequitable for a Court to make Orders regarding the sale of, say, a $5 million house with respect to the Trustee's claim under a Bankrupt Estate with creditors of $500,000.

2.10 Loopholes

Our experience tells us that an industry will evolve at the high income earning level to circumvent the proposed measures being brought in.

Many highly educated minds will turn to finding ways to protect high income earners from the effects of the Bill. As such, those parties most likely to be affected by the changes will be those people unable to afford to protect their assets from these changes – not the parties that the changes are seeking to capture.

Possible deficiencies in the proposed legislation are:

- *Definition of Tainted Purpose (section 139AFA)* - The issue is how much a transferor can dilute the "main" purpose of a transaction by showing "alternate" purposes. For example, a transferor can make a transfer of property for many good reasons including, but certainly not limited to, tax planning, providing for the needs of family members, helping out friends, donations to charitable causes, straight out gifts etc. It may be difficult for the trustee to maintain that the main purpose of the transaction was "tainted" where there are no records and the bankrupt and the other party to the transaction claim that the purpose was not tainted.

- *Loan Discharge (section 139AK)* - It is unclear what happens in the circumstance where a bankrupt discharges the loan(s) of family members pre-bankruptcy, but derives no benefit from the assets acquired through the loans (e.g., If a bankrupt discharges the mortgage on his adult daughter's family home and he has never stayed at that home, it would be very difficult to deem the property, or funds utilised to discharge the loan as "tainted money" or "tainted property").

Furthermore, the reality is that Section 116 non-divisible property provides many avenues for sophisticated minds to devise schemes to defeat the intention of the legislation.

2.11 Practical application

We note that the Joint Taskforce that wrote the report that formed the basis of the Bill was compromised of government agencies and did not have any private sector representation. We should make the point that the IPAA has been represented on the Bankruptcy Reform Consultative Forum and at the Forum have consistently made the point to government that there were serious problems with the practical application and enforcement of the proposed changes. These fears have not been overcome when considering the specific legislation.

Following are some examples of anomalies that we consider may occur under the Bill if introduced in its current form:

- Is a spouse's wedding ring purchased through personal exertion income ultimately recoverable by the Trustee in bankruptcy? If the bankrupt has obtained a benefit, yes it would be recoverable. Does this mean that people will be unable to buy gifts for their spouses in the fear that in the event of bankruptcy that gift will be recoverable?

- If a car is purchased as a gift for a child by a bankrupt parent when there is no hint of insolvency and the bankrupt parent rides in the car from time to time, is this by definition "tainted property" and recoverable by a Trustee? Yes - there would be no proposed time limit between when the vehicle is purchased and the date of bankruptcy in this example. Does this mean that no parent can buy a gift for their child on the fear that in the event of bankruptcy that gift will be recoverable?

- If a bankrupt makes a contribution to a relative's mortgage whilst living with them that appears to be caught by the legislation. No guidance can be ascertained from the explanatory memorandum or the legislation as to how the financial interest is to be calculated, especially with payments over time in an appreciating market.

- If a bankrupt receives an inheritance (at any time in their life) and places it into a family trust and used some of those proceeds to assist children in purchasing a home, this would be caught by the legislation, particularly if the bankrupt stayed in the child's house at some time. Again, no guidance can be ascertained from the explanatory memorandum or the legislation as to how the financial interest is to be calculated.

- More broadly, if a bankrupt was left out of a will because of their insolvency, is that a scheme to defeat creditors and therefore grounds for a Trustee in bankruptcy to contest a will? This is not clear.

- If a husband buys his wife jewellery and states that he does not like jewellery, he in theory gets no benefit by seeing his wife wear jewellery, then this may well be exempt property. If the jewellery purchased was worth in the order of $250,000 and the wife then resells the jewellery and purchases a house with proceeds this may not be tainted property. This seems to be a way to defeat the legislation as proposed.

- If a bankrupt pays his surplus income (after the satisfaction his compulsory contributions requirement) to his wife's mortgage what is the result? This is unclear.

2.12 Summary of issues

To summarise, our position in respect of the amendments to Division 4A of Part VI is as follows:

- the Bill will result in an expectation gap for creditors;
- the extra investigations will increase the costs to the estate when Trustees are already under pressure to contain costs;
- it is already difficult for Trustees to obtain funding for investigations and recovery actions, this issue is not addressed;
- there is no timeframe prescribed in the proposed amendments and this lack of a timeframe will impose unrealistic obligations on Trustees;
- there are viable options put forward for the establishment of a timeframe;
- it is unclear as to which bankruptcies the Bill will apply to;
- there are unintended consequences for Trustees if the legislation is retrospectively applied;
- the successful recovery of assets is dependent on the identification of those assets and the Bill does not address this;
- books and records are only required to be retained for five years for tax purposes but Trustees are required to investigate for an unlimited period;
- proposed section 139AFB is unfair and discriminates against sales of assets to related parties;
- there is ambiguity in relation to the matters that the Court is to take into account when making an order;
- strategies to identify and exploit loopholes in the legislation will continue to be developed by those persons whom this legislation is intended to capture; and
- there are many practical issues in the application of the Bill.

From the IPAA's and Trustees' perspective, the most important of the above issues is the establishment of a timeframe so that there is a limit on the investigatory obligations imposed on Trustees and a limit to the costs that must be incurred to properly investigate a bankrupt's affairs.

3.0 Amendments relating to the interaction between Family Law and Bankruptcy

It is a fact that family law practitioners and judges have very limited experience in the law and practice of bankruptcy. Given the family law's focus on non-financial contributions to a matrimonial arrangement, this will in all likelihood throw up erroneous applications of bankruptcy law. This will, in turn, lead to confusion in the proper application of the Bankruptcy Act.

We also question who will fund the Trustee to be represented in Family Law Court proceedings, particularly in the circumstance where all of the material assets of the Bankrupt Estate are subject to the Family Law Court proceedings? In this instance, the Trustee is not guaranteed of a successful or partially successful result to enable him or her to pay for his or her representation work in the proceedings, or to pay for legal counsel.

Further, Bankruptcy Trustees are not family law experts. Accordingly, where family law proceedings are on foot or being actively contemplated, Trustees will need to obtain expert advice on the family law implications on the Bankrupt Estate. This will be an added burden on the Bankrupt Estate and further, there is no guarantee that the Bankrupt Estate will have sufficient funds at its disposal to obtain such advice.

4.0 Amendments relating to income contributions

We have identified several issues in respect of this Schedule to the Bill:

- The bankrupt may well have structured his or her business activities in a "tax effective manner" but the Trustee may not be comfortable with the legality of these arrangements from a Tax Law perspective. Accordingly, if the Trustee administers the Supervised Account in a less tax effective way than that previously conducted by the bankrupt, could the Trustee personally (and/or the Estate) be held liable for the "extra" payments that will have to be made to the ATO? In these circumstances it would be prudent for a Bankruptcy Trustee to obtain expert tax advice. Who will be liable to pay for this extra impost - the Trustee? the Estate? or through the Estate, the creditors?

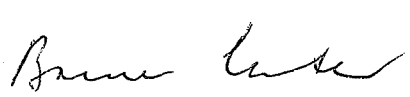
- The Act does not allow a Trustee to utilise an overdraft facility with respect to the Supervised Accounts Regime. This will pose considerable difficulty in seasonal businesses, particularly where the Regime is commenced during a low cashflow period and where there are extremely good prospects, subject to the bankruptcy being funded in the meantime, of obtaining large cashflow surpluses at a future date. Accordingly, in our opinion, the utilisation of an overdraft account should be left to the discretion of the Trustee.

- What happens in the circumstance where the bankrupt takes steps to appeal the Trustee's underlying Income Contributions Assessment? If the Income Contributions Assessment is subject to an appeal, will this prevent a Trustee from determining that the Regime will apply to the bankrupt? Section 139ZIC is silent on this issue. It would be preferable if the Trustee could apply the Regime whilst the underlying Income Contribution Assessment is being reviewed under appeal from the bankrupt. Otherwise a bankrupt may use this mechanism to frustrate the Regime.

* * * * *

The IPAA would welcome the opportunity to meet with the Committee to discuss our submission. Any initial queries should be directed to Mr Bruce Carter, President of the IPAA on 08 8235 7661, Mr Paul Cook, Chairman of the IPAA's Bankruptcy Subcommittee on 03 6223 2555 or Ms Kim Arnold, our Technical Director on 02 6360 0052.

Yours sincerely



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