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AMA

04/248

18 June 2004

RECEIVED
22 JUN 2004

BY: *Lylian Gould*

Submission No: 77

The Hon Bronwyn Bishop MP
Chair
House of Representatives Standing Committee
on Legal and Constitutional Affairs
Parliament House
CANBERRA ACT 2600

Dear Ms Bishop

Re: Inquiry Into The Bankruptcy Legislation Amendment (Anti Avoidance And Other Measures) Bill 2004

Please find attached a submission by the Australian Medical Association to the above Inquiry.

The AMA, whilst supportive of measures to address the deliberate use of bankruptcy laws by high income earners to avoid tax and other debts, is concerned that the proposed legislative scheme goes well beyond its apparent intention. It has vast implications for the community in general and, in particular, the small business sector.

The AMA would be pleased to assist the Inquiry during the consultation process and to that extent, any further questions should be directed to the undersigned.

Yours sincerely

Warwick Hough

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Director, Workplace Policy Department
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Enclosures: 1

**SUBMISSION TO THE STANDING COMMITTEE ON
LEGAL AND CONSTITUTIONAL AFFAIRS**

**INQUIRY INTO THE BANKRUPTCY
LEGISLATION AMENDMENT
(ANTI AVOIDANCE AND OTHER MEASURES) BILL 2004**

**PREPARED BY THE
AUSTRALIAN MEDICAL ASSOCIATION**

JUNE 2004

**SUBMISSION TO THE STANDING COMMITTEE ON
LEGAL AND CONSTITUTIONAL AFFAIRS**

**INQUIRY INTO THE BANKRUPTCY LEGISLATION AMENDMENT
(ANTI AVOIDANCE AND OTHER MEASURES) BILL 2004**

INTRODUCTION

The Australian Medical Association (AMA) has 28,000 members throughout Australia, representing the entire medical profession. While the AMA is renowned for its role as professional body, it also has a strong small business base with many of our members operating private practices in the various fields of speciality as well as General Practice. Many of these operate as sole traders and partnerships.

The AMA's response to the Bankruptcy Legislation Amendment (Anti Avoidance and Other Measures) Bill 2004 ("the Bill") is therefore constructed with a view to the implications for the medical profession as well as small business in general.

On the face of the explanatory memorandum attached to the Bill and the media release¹ from the Chairman of the Standing Committee on Legal and Constitutional Affairs ("the Committee") one could easily believe that the Bill is simply aimed at preventing high income professionals from using bankruptcy laws as a means to fund an extravagant lifestyle by avoiding their taxation and other obligations.

Indeed the Bill draws heavily on the findings of the *Joint Taskforce Report on the Use of Bankruptcy and Family Law to Avoid the Payment of Tax*, which identified a small but significant number of high income debtors, typically professionals, who use bankruptcy to avoid paying their taxation and other debts. These debtors had the ability to pay their debts, but instead funded a lifestyle made possible only through the non-payment of debts and the build up of assets in the names of related parties.

If this was simply the intent of the Bill and represented the full extent of its reach, then the Bill would have the support of the AMA. However, a careful reading of the proposed legislation reveals that it casts a far broader net that has serious implications for sole traders and partnerships, directors of incorporated bodies and all professional persons. It goes well beyond the boundaries identified in the explanatory memorandum and any justification for change identified in the above Joint Taskforce Report.

THE EXISTING LAW

Existing provisions of the Bankruptcy Act 1966 ("the Act") give significant scope for creditors to recover payments and transfers of property made by a bankrupt prior to his or her bankruptcy.

¹ "Bishop announces Inquiry into proposed changes to bankruptcy laws" – media release dated 21 May 2004.

Broadly speaking, recovery is possible under the Act in the following circumstances:

- Transfer of property by a person who later becomes bankrupt if it was made in the 2 year period before the commencement of the bankruptcy (5 years in the event that they were insolvent at the time) where there was no consideration, or consideration was below market value (Section 120)
- Transfer of property that was likely to have become part of the bankrupt's estate if the main intention was to defeat creditors, and that there was fraudulent intent on the part of the bankrupt. There is no time limit attached to this entitlement (Section 121)

The above framework provides clear rules for small businesses and professionals to undertake financial planning and have some measure of protection for their personal assets in the event of a future bankruptcy. Sole traders and partnerships, in particular, are able to transfer assets to related parties in order to place some limit on their liability. This invariably takes place at a time when they were not in any way at risk of bankruptcy and nor were they overtly motivated by a deliberate desire to prevent, hinder or delay the claims of creditors.

People do not go into business with the intention of going bankrupt and the ability for sole traders and partnerships to be able to transfer assets is a means of protection against personal liability that is analogous to corporate limited liability. The assets of the business remain available to creditors.

Within the current regulatory environment, creditors are offered a high degree of protection. In addition, prudent credit control practices can be employed by creditors to maintain cash flow and minimise their potential exposure to bad debts. These include:

- Company & title searches
- Credit reference checking
- Requiring assets as security
- Personal guarantees
- Legally binding credit application forms
- Acceptance of credit card payments
- Requiring debtors to lodge deposits for the provision of goods or services
- Factoring
- Pro-forma orders
- Appropriate follow up of outstanding debts

The AMA accepts that while the Australian Taxation Office (ATO) does not have access to these "commercial" tools, it does have access to an enormous amount of information and also has the resources to track those industries or professions where it can identify higher rates of non-compliance with taxation laws. Indeed, the Joint Taskforce Report focuses on the problems that have been encountered by the ATO in pursuing tax debt amongst a limited range of professions, rather than the business community. This provides a firm basis for the proposition that legislative changes to address these problems should be carefully targeted.

THE PROPOSED CHANGES

The proposed legislative scheme can best be described as the provision for an all pervasive approach to the recovery of property and assets that were acquired by a bankrupt at any time before their bankruptcy, and to include assets transferred to their family or an associated entity.

Despite being touted as addressing the “high flyers”, by incorporating the changes in the general provisions of bankruptcy law, they potentially capture every business in Australia, and indeed the whole of society.

Under the proposed changes existing time limits for the recovery of transferred assets disappear, with the Court having the unlimited right to examine transactions. The onus of proof falls on the bankrupt to show that a transfer was not for a tainted purpose and the Court will have a wide degree of discretion in the exercise of its powers.

IMPLICATIONS

Entrepreneurship

The major implication of the Bill is that it undermines one of the major planks on which the economy operates – entrepreneurship. The concept of limited liability has long been recognised as providing an appropriate means by which individuals are encouraged to take on risk. Small businesses operating as sole traders and partnerships will, in particular, be hit hard by the proposed changes as the thrust of laws is to deny them access to some reasonable measure of protection for their personal assets.

In the absence of such protection it follows that people will reconsider their investment decisions. It is arguable that many potential small business owners will simply become risk averse, unless there is reasonable certainty available with respect to bankruptcy laws and those laws afford them some legitimate protection.

The consequences for employment, innovation, and the continued growth of the small business sector are significant. Small business has contributed strongly to jobs growth in Australia and in order for this to continue, an environment that is conducive to taking on risk must be encouraged, rather than hindered.

Comments that were attributed to the Attorney General, The Hon Philip Ruddock MP, in the Australian Financial Review state that *“If people think that – in relation to individual sole traders or partnerships that have never been incorporated – they are able to assume protection through manipulation of bankruptcy provisions, they should think again.”*²

These comments ignore the fact that sole traders and partnerships have over many years used legitimate strategies to minimise their personal exposure to risk, other than those available through incorporated structures. Whether the Government appreciates it or not, these practices are now well and truly part of the business landscape. Disturbing these arrangements will potentially have enormous implications for the financial affairs of the large number of sole traders and partnerships that currently operate in Australia.

² Page 29, “The new assault on personal assets” - Australian Financial Review, 12 June 2004

According to the latest statistics available from the ATO, in 1999/2000 nearly 500,000 partnerships lodged a tax return. This figure alone demonstrates the enormous reach and potential consequences of this Bill for the small business community.

Countries throughout the world recognise the importance of incentives to undertake risks and the need for business people to be able to have some measure of protection for their personal assets. The proposed laws provide creditors with potential access to assets that will have been created a long time prior to debts being incurred and the AMA is not aware of any bankruptcy system in the world that provides such far reaching powers to claw back the assets of bankrupts.

From the particular perspective of the medical profession, this may well force many doctors to reconsider the advantages of going into (or remaining in) private practice. During the recent medical indemnity crisis it became clear that many older doctors (particularly specialists over 55) were contemplating premature retirement to avoid exposing their family to the consequences of the increased risk of practising medicine. The Government took quick action to address this problem because of the potential for further workforce shortages. These very same doctors might find this new threat to their family's security as being the last straw.

In addition, with chronic GP shortages already having an impact on the public's access to primary care, anything that further diminishes the attractiveness of General Practice will only exacerbate these problems.

Retrospective Application

The proposed changes are retrospective in operation. In this respect, financial arrangements that were legitimately established under existing laws can now be opened up to scrutiny. This is contrary to reasonable expectations of regulatory certainty, particularly where a business arrangement is not motivated by fraudulent or dishonest purposes.

This Bill may also have significant tax consequences. Many small businesses will need to consider the re-organisation of their business and financial affairs, while the powers available to trustees will allow them to disaggregate previous transactions.

No-Fault Bankruptcies

The proposed laws do not recognise that many business bankruptcies are "no fault" where small businesses become bankrupt as a result of bad debts, failures of companies they trade with, loss of contracts for the provision of goods or services, strike action, or sudden changes in the economic environment. They often have little or no control over these situations, yet this Bill will expose them to bearing the entire consequences of these types of events.

Insurable Risk

A number of statements have been made by the Attorney General that appear to provide some insight into the Government's views on the Bill. In particular, on the topic of risk the Attorney General made the following observation:

*"it is the role of professional indemnity insurance – not the bankruptcy system – to deal with these sorts of risks."*³

The AMA strongly believes that individuals and businesses should carry appropriate insurances, however, it is simply not possible to insure against all potential risks. World-wide problems for the insurance industry have seen the rationalisation of policies and small businesses and professionals have found it extremely difficult to access affordable insurance cover for some activities.

In an increasingly litigious society the impact of one single case can have far reaching ramifications for an insurance policy carried by an individual, professional or business. A large damages award by a Court can render insurance policies inadequate overnight, force insurance companies to reconsider the terms on which a policy is offered, or lead to dramatic increases in premiums. The corporate failure of an insurer, such as HIH, also dramatically illustrates that insurance alone may not be enough.

The proposed laws also expose directors of incorporated bodies (including those of volunteer organisations) to greater financial risk. Requirements for personal guarantees and the possibility that Director's insurance will not cover all circumstances means that their assets and those of their family will be at greater risk if the Bill is passed.

Importantly, it is not possible to insure against business failure, which is why the Act should remain a legitimate means by which some personal asset protection is allowed.

Red Tape

With the unlimited ability for the Court to examine past transactions comes the need for small business to keep additional records relating to the transfer of assets for an unlimited period of time. With the onus of proof falling on the bankrupt to show that they did not transfer the asset for a tainted purpose there will be no alternative but to keep extensive records regarding a transaction. It is unlikely, particularly with assets transferred some time ago, that the recipient will be able to disprove the presumption that the bankrupt had a tainted purpose.

The changes will also force many sole traders and partnerships to consider incorporation in order to place some limit on their potential liability in the event of business failure. Many small businesses do not currently take up this option as it involves additional compliance costs.

The Government has recognised the impact of red tape on small business and repeatedly committed itself to reducing this burden, however, the proposed Bill will simply add more red tape.

³ Speech by the Attorney General 14 May 2004

Uncertainty

Existing laws clearly set out the circumstances under which assets can be recovered and, as identified earlier, this provides a degree of certainty with respect to planning of financial affairs.

The proposed laws give the Court a wide degree of discretion in the exercise of their powers and immediately introduce a significant degree of uncertainty into bankruptcy law. Although the Bill does attempt to provide some guidance in Section 139f about what should be taken into account by the Court when considering whether it should allow the recovery of transferred assets, the guidelines can be interpreted broadly and will effectively permit the Court to set an as yet unclear agenda for how the legislation will be interpreted. This will result in significant uncertainty for professionals, small business owners and their advisers – which will simply discourage entrepreneurship and risk taking.

WHAT IS THE ALTERNATIVE?

There is no doubt that the actions of those high income professionals who deliberately set out to avoid the payment of tax and other debts needs to be addressed, however, draconian legislation that extends to the whole of society is not the way to proceed and nor has any evidence been provided to support such an approach.

Various reforms have already been enacted, particularly with respect to the legal profession, to ensure that those individuals who deliberately use bankruptcy as a means to improperly shield themselves from debt are unable to continue in practice. Barristers were identified by the Joint Taskforce Report as the major professional group taking advantage of bankruptcy laws to avoid the payment of tax debts, so the reforms already instituted address much of the problem.

The AMA believes that with some amendment, current laws could be further tightened to allow the ATO to recoup outstanding tax debts. In this regard, the Act could be amended to provide that existing time limits prescribed under the Act for the recovery of transferred assets would operate from the time the person became bankrupt, or the date of individual's last tax return – whichever is earlier.

The Joint Taskforce Report clearly identified the non-lodgement of tax returns as the means by which the timely payment of tax was avoided. The AMA proposal uses this as a key indicator of some form of deliberate avoidance of tax obligations and provides a simple solution focused on those individuals who clearly set out to avoid the payment of tax and other debts.

Overall, the AMA believes that the proposed Bill is a disproportionate response to a significant, but very limited problem. Proposed changes potentially affect the whole business and professional community, not just the few high flyers who deliberately set out to "cheat" the system.

A more targeted approach is required, which provides members of the business and professional community with legitimate access to the protection of their personal assets, continues to foster a culture of entrepreneurship and recognises that insurance does not provide all the answers.

Prepared by the Australian Medical Association, 18 June 2004.