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TAXATION INSTITUTE OF AUSTRALIA

1 July 2004

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

Dear Sir

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

The Taxation Institute of Australia (the Taxation Institute) is writing to the House of Representatives Standing Committee On Legal and Constitutional Affairs (the Committee) to express its concerns about the proposed *Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004* (the draft Bill).

By way of background, the Taxation Institute is a tax education body and was established in 1943. Our 11,000 members range from tax advisers to the small and medium enterprise sector, to senior tax practitioners in the legal and accounting professions, as well as the Public Service. We are a regular contributor to all levels of Government on taxation matters and our reasoned views are highly regarded.

At the outset we would like to confirm our strong support for the stated policy objectives of the draft Bill as set out in the draft Explanatory Memorandum. We also support the numerous submissions lodged by other professional bodies, who without exception question the draconian nature of the Bill and its practical and effective operation in resolving the problems with the existing Bankruptcy laws.

Furthermore, the period of time allowed for consultation on this draft Bill was grossly inadequate, as was interaction with the private sector. It is noted that the Joint Taskforce did not have any private sector representatives; only government agencies were represented on the Taskforce. Accordingly, we endorse the call by professional bodies for a commission of inquiry to examine the policy and operation of the Bankruptcy Act as a whole before this bill proceeds any further.

The Taxation Institute appreciates that the *Joint Taskforce Report on the Use of Bankruptcy and Family Law Schemes to Avoid Payment of Tax* (the Taskforce Report) identified a number of unsatisfactory practices in the bankruptcy area that need to be addressed. However, we are concerned that the draft Bill as it stands is not a satisfactory response to the recommendations made in the Taskforce Report. The draft Bill goes far beyond what our members would regard as appropriate or reasonable to protect the interests of creditors in an insolvency situation.

The proposed new rules in the draft Bill run contrary without exception to long settled law in relation to property rights and estate planning. They dramatically affect the rights of *everyone* to be able to protect their assets legitimately. In particular, the application of the draft Bill goes well beyond the high-income earners identified in the Taskforce Report. Its integrity is further undermined by the inequitable failure to make the carve outs for small business or circumstances of misfortune or economic conditions recommended in this Report.

As a result of the inadequate consultation process and the Taxation Institute's focus on taxation issues, we are not in a position at present to analyse the draft Bill in detail. However, we are aware of and support other comprehensive analyses and criticisms of the draft Bill. Therefore, by way of additional commentary, set out below are the Taxation Institute's main areas of concern with the draft Bill, followed by some general comments on a way forward for reform in this area.

1. AREAS OF CONCERN

1.1. Reversal of onus of proof, claw back and scope of application

Under the proposed rules, the burden of proof as to the purpose in making a payment or transfer is on the transferee and not the trustee in bankruptcy. This is contrary to the current situation under the Bankruptcy Act where this onus is on the trustee in bankruptcy.

Also, there is an intent in the proposed rules that "tainted money" or "tainted property" with a "tainted purpose" is to be traced through to retained funds or property acquired by the application of the funds (e.g., section 139I). However, a bankrupt does not need to control the entity from which the bankrupt obtains a direct or indirect benefit (which is presently required by the current Division 4A).

The practical effect of this reversal of the onus of proof and the lack of the need for a bankrupt's control is that when anyone (and not just high income earners) goes bankrupt, then *everyone* connected with the bankrupt will effectively have to prove they obtained their assets other than from the bankrupt, if they ultimately want to retain their assets.

This clearly flies in the face of the face of claims by the Attorney General that the new rules are aimed principally at high income earners living the high life even though bankrupt (Press Release 074/2004, 14 May 2004).

Every business structure and every person who is or could be in business is affected. Under the draft Bill, it will simply be almost impossible for anyone to deal with their assets in a way that could legitimately protect them from business misfortune, regardless of whether or not a high-income earner is involved. Even an unrelated, unsuspecting arm's length purchaser is not protected, unless the purchaser can prove the absence of tainted purpose.

This is unacceptable in intent and draconian in effect, going well beyond only affecting people who have deliberately and knowingly set about to avoid being able to contribute to their legal obligations by using bankruptcy to put their assets beyond the control of their creditors.

If this regime is implemented we envisage a situation of long and protracted legal disputes tying up the resources of our legal system for years without in the end a result in favour of creditors. We cannot even begin to speculate on costs involved in this litigation and how such costs would be funded by all parties involved.

1.2. Anti-avoidance

The anti-avoidance provisions are too wide in their application. For example, these provisions could apply to two quite essential incidences of asset protection:

- clauses which strip the power of appointment from an appointor who has committed an act of bankruptcy; and
- contingent gifts in wills, which are stripped if the beneficiary has committed an act of bankruptcy at the date of death.

In relation to the first instance, the outcome is probably of little consequence in that the power of appointment is not divisible property. However, whether or not property owned by the trust may be exposed to the anti-avoidance provision is a completely different question.

More importantly, however, in the second instance it would appear that the anti-avoidance provision would be satisfied where a gift in a will is expressed to be contingent on the beneficiary not having committed an act of bankruptcy. Compare this to a gift that directs funds to a trust but does not expressly contain such a power. This is unlikely to be caught (unless of course the parties manifest the intention in writing that the testamentary trusts were used for this very reason).

1.3. Carve Outs

There are no exclusions from the proposed rules. This is in marked distinction from the Taskforce Report, which recommended that the following might deserve exclusion:

- persons who become bankrupt merely through misfortune or adverse economic conditions; and
- small businesses.

As indicated above, in introducing the draft Bill the Attorney General emphasised the application of the changes to high-income earners. This is simply not the case. The rules apply to everyone.

The Taxation Institute strongly recommends that, should the rules continue to be of general application, there is an urgent need to introduce the above carve outs recommended in the Taskforce Report to restore some measure of equity to the proposed rules.

We would be pleased to assist on the appropriate definition of small business for the purpose of a carve out.

1.4. Retrospectivity

The proposed rules are retrospective in their effect. This is in the sense that they apply to all bankruptcies current on or after commencement of the provisions. This is so notwithstanding the fact that the transactions, which might be impugned, were entered into many years ago.

It does not matter when the assistance was provided by the bankrupt to a family member or other family entity. Unless the transfer of property is an exempt full-value transfer, there is no time limit. This element of retrospectivity element makes the proposed rules inequitable.

A transaction entered into for purely family reasons with no business creditor issues at the time runs the risk of being permanently tainted with no timeline being in place to prevent such a transaction being subject to the new laws years after the innocent event. The new laws go beyond what has been considered by the government as fair or appropriate even in our taxation laws dealing with powers of amendment for tax assessments. However if the Australian Tax Office needs more powers to counter practices to avoid collection of tax then such powers should be dealt with under the tax laws.

2. A WAY FORWARD FOR REFORM

The Taxation Institute supports in principle the need to make sure that the law prevents people from knowingly using bankruptcy to put their assets beyond the reach of creditors. This type of activity undermines the credibility of the bankruptcy system.

As indicated above, we endorse the call by professional bodies for a commission of inquiry to examine the policy and operation of the Bankruptcy Act as a whole, noting that the original Joint Taskforce did not have any private sector representatives; only government agencies were represented on the taskforce.

Furthermore, the proposed draft Bill is a classic case of using a “sledge hammer to crack a nut” by casting the net too widely. It is particularly unfair in this regard for small business and people affected simply by misfortune or economic conditions.

Therefore, any changes to the law should be better targeted. The Taskforce Report’s recommendations in respect of carve outs for small business and those affected by misfortune or economic conditions need to be incorporated into the draft Bill. However, there is also a need to identify more precisely the deficiencies in the bankruptcy laws and to implement amendments that deal only with those deficiencies.

It is only through this process that a proper balance can be achieved between protecting the rights of people to protect their assets with their obligations towards their creditors.

If you have any queries in relation to the points raised above, please contact the Taxation Institute’s Tax Director, Michael Dirkis, on 02 8223 0011.

Yours faithfully

Neil Earle
President