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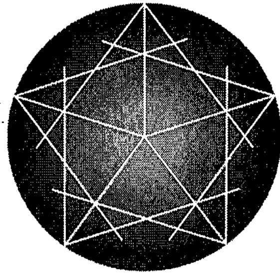
Submission No: 118



FPA
FINANCIAL PLANNING ASSOCIATION
of Australia Limited

SUBMISSION

to

The Secretary

House of Representatives Standing Committee on Legal & Constitutional Affairs

PROPOSED CHANGES TO BANKRUPTCY LAWS

30 JUNE 2004

Prepared by:
The Financial Planning Association of Australia Limited

1 Introduction

The Financial Planning Association of Australia Limited ("**FPA**") is the peak professional organisation for the financial planning industry in Australia. The organisation has approximately 14,000 members (organised through a network of 33 chapters across Australia) and a state office located in each capital city, except Darwin. The FPA represents qualified financial planners who manage the financial affairs of over five million Australians who have a collective investment value of over $560 billion.

2 Overview

The recent release of the exposure draft of the *Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill* 2004 (Cwlth) ("**Draft Bill**") has generated considerable concern for FPA members and their clients.

The FPA considers that the Draft Bill, in its current form, will have implications far beyond the primary aim of addressing "the issue of high income professionals using bankruptcy as a means of avoiding their taxation and other obligations" [1].

In no way does the FPA or its members condone the deliberate attempts by some individuals and entities to avoid their taxation obligations. We submit that unless the Draft Bill is significantly amended, however, its implementation will almost certainly have a number of unintended negative consequences, some of which could prove quite serious.

Our Submission focuses on the following points:

- The Draft bill will 'capture' a much wider range of individuals and entities than is intended or anticipated, and will have some unintended negative impacts on a variety of parties.

- The aim of the proposed reforms could be achieved, without the unintended negative consequences, by confining the reforms to the resolution of the conflict between family law and bankruptcy law (see '6' below).

3 Impetus for the reforms

According to the Explanatory Memorandum to the Draft Bill (see paragraph 3), the proposed legislation aims to:

"...

(a) improve the ability of bankruptcy trustees to recover assets from bankrupts who do not own these assets personally but who have funded the acquisition of assets by third parties whilst retaining the use or benefit of those assets;

[1] See paragraph 9 of the Draft Bill's Explanatory Memorandum.

(b) provide a more effective means of collecting income contributions from bankrupts who do not receive their income as a salary or wage;

(c) prevent the misuse of financial agreements as a means of avoiding payment to creditors; and

(d) address longstanding issues concerning the interaction between family law and bankruptcy."

We consider these to be commendable aims. Nevertheless, our review of the Draft Bill (and associated documents [2]) indicates to us that, should the proposed legislation be enacted, there will be negative impacts, including those outlined in '4' & '5' below.

4 Unintended negative consequences of the Draft Bill

The following unintended negative consequences could result from this legislation:

A. Having it apply to a far wider range of entities than intended (ie, to professionals, small-business operators and farmers, as opposed to the comparatively few 'high fliers').

B. Perpetuating the simplistic and unfair stereotype that every bankruptcy and/or discretionary trust is suspect.

C. Treating personal and corporate insolvency differently and potentially discriminating against the former.

D. Discouraging those in business from appropriate entrepreneurial risk-taking.

These potential impacts warrant serious and careful consideration, not only because they will impact on the lives of those who have become bankrupt without any 'tainted purpose', but because they could compromise our nation's economic health – which in turn will cause more unintended negative impacts for those innocent of manipulating the bankruptcy route for tax avoidance purposes.

We therefore challenge the statement that: "The amendments proposed by this Bill have no significant financial impact." [3] They may not have a **direct** financial impact, but they are likely to have a considerable negative impact!

[2] Such as the Explanatory Memorandum and the relevant media releases.
[3] In the Explanatory Memorandum to the Draft Bill. See paragraph 8.

a) Misapplication of the legislation

As to the intended target(s) of the proposed reforms, of particular relevance is paragraph 11 of the Explanatory Memorandum to the Draft Bill, which notes (in reference to the Taskforce whose report prompted the reforms) that:

> "The Taskforce identified the problem of a **small but significant number of high-income debtors** [4], typically fee-for-service professionals, who use bankruptcy to avoid paying their taxation and other debts. These debtors have the ability to pay their debts but instead fund a lifestyle made possible only through the non-payment of debts and the build-up of assets in the names of related parties".

It continues:

> "Some offending debtors divert income and assets to other parties in a manner **designed to thwart** the capacity of **the bankruptcy trustee** to realise their value for the benefit of creditors. In such cases the return to creditors in a bankruptcy more often reflects the bankrupt's ability to structure their affairs in a certain way rather than their substantive or real wealth".

Rather than tailoring the proposed legislation to those few 'living the high life', the Draft Bill is likely to 'capture' many small businesses, professionals and farmers; indeed, anyone who has issued a personal guarantee in the normal course of securing funding for their business.

Due to the indefinitely retrospective nature of the proposed reforms (see '5a'), these people will no longer be able to rely on the security of their present financial situation. Nor can they be assured that their personal assets (such as the family home) are not in jeopardy.

As Mr Gess Rambaldi (a partner of Pitcher Partners) states:

> "Australian small business and professionals are paying for the sins of a small group of recalcitrant NSW barristers...It will create uncertainty and lack of financial security for tens of thousands of Australian families whose breadwinner takes risks to create wealth in Australia". [5]

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[4] Bolding is our emphasis.

[5] Quoted in Robert Gottliebsen's *'Bankrupting the spirit of risk'* article in the 22.5.04 *Australian.*

b) Questioning the legitimacy of all bankruptcies and discretionary trusts

The Draft Bill and associated documents clearly perpetuate the notion that very few, if any, bankruptcies are legitimate. It is evidently presumed, by those who drafted the legislation, that bankruptcy is used by individuals and small businesses primarily as a device to shield assets from creditors.

We believe that it is too simplistic an approach to presume that the majority of individuals and small businesses who go bankrupt do so voluntarily. For ordinary Australians and for the most part, becoming bankrupt means a significantly reduced quality of life, not only for the individual concerned, but also for their immediate family.

Discretionary trusts are a crucial means by which the personal assets of thousands of Australian families are safeguarded from unforeseen financial disaster. Nevertheless, as stated in the Explanatory Memorandum:

> "The amendments proposed by this Bill represent a fundamental shift away from the perceived legitimacy of these arrangements." [6]

c) Differentiating between personal and corporate insolvency

In the case of companies, a counterpart to the discretionary trust (in terms of asset protection) is the concept of limited liability. This well-established practice operates to protect those who invest in public and private companies, in the event of financial calamity, by limiting the shareholders' liability to the extent of their investment.

In this respect, we quote a 31.5.04 letter from Mr Michael Hart [7] (Managing Partner of Cleary Hoare Solicitors) to Mr Alan Jones:

> "...the proposed legislation strikes at the core purpose of family trusts – the protection of trusts assets against non-fraudulent financial calamity. If the legislation is intended to operate where there is no fault on the part of those who later become bankrupt then, on equivalent reasoning, there is no basis for retaining the concept of limited liability. However, it would, no doubt, be unthinkable that limited liability be taken away, because that would strike at the heart of public companies which seem to be more sacrosanct than private business."

[6] At p 16.
[7] Who kindly provided us with a copy.

d) Likely economic impacts

Should the Draft Bill be enacted as is, it will inevitably 'slow-down' a key engine of economic prosperity – ie, it will discourage entrepreneurial risk-taking by individuals and small businesses.

Indeed, the proposed reforms may encourage the premature winding-up of businesses or the early retirement of individuals, as a means to avoid jeopardising personal assets. This increased 'conservatism' will significantly impact upon business enterprise and our nation's economic health. Surely, another unintended negative consequence.

5. Other matters & impacts

a) Retrospective operation and its political risks

Our understanding of the intended retrospective operation of the Draft Bill is as follows.

Transfers of assets for full market value will be exempt from the new rules if:

- the transfer occurred more than 10 years before bankruptcy; or
- the transferee did not know that the bankrupt had a 'tainted purpose' at the time of the transfer of the property.

Conversely, transfers of assets for less than full market value will not be exempt from the new rules, **no matter how long ago such transfers occurred**.

We note that historically there are political risks in the proposed retrospective operation of changes.

b) The presumption of 'tainted purpose' of asset transfers

Another concerning aspect of the proposed legislation (and one related to '5a' above) is the imposition of the **presumptio**n that any asset transfer made to a third party was done to avoid having the asset being subject to a claim by a creditor.

This will effectively reverse the 'onus of proof'. No longer will a creditor bear the responsibility of substantiating a claim of fraud. Rather, the transferee will be required to prove the absence of a 'tainted purpose' for the transfer at the time when the entity acquired the asset.

Designed to make it easier for a trustee in bankruptcy to realise the value of assets and income for the benefit of creditors, this measure will conversely introduce unnecessary uncertainty regarding the security of personal assets, including those that may have been transferred decades before the individual became bankrupt.

Ordinary Australians who regrettably find themselves in a bankruptcy situation are likely to strongly resent this rebuttable presumption, particularly as it will have a double impact when aligned with the retrospectivity provisions.

c) Increased reliance on insurance

The Attorney General, Mr Ruddock, has observed that:

> "Some people hold the view that these asset protection strategies are a legitimate way of insuring against professional negligence or misconduct actions. **It is the role of professional indemnity insurance** – not the bankruptcy system – **to deal with these sorts of risks**".[8]

However, recent changes in availability of professional indemnity insurance mean that insurance cover for professional indemnity is often heavily restricted and conditional, and cannot be presumed to be sufficiently reliable to protect, from litigious creditors, the family homes of those providing services (including advisory services provided by Australian Financial Services license-holders).

Also, even if a uniform capping scheme is implemented, it will not address **past** exposures and will therefore be of little benefit to smaller businesses that don't operate professional services.

d) Impact on advisors and their clients

If the Draft Bill passes as is, there will be significant impacts for many ordinary Australians and for a range of professionals who advise them.

For example, anyone wishing to transfer assets in the future, would need to take extraordinary measures to avoid having the transfer labelled as 'tainted'. Whilst they would be unwise, in this event, if they did not seek the advice of a **Certified Financial Planner** (CFP®) they would incur the cost of such 'financial strategising' advice. And whilst the benefits of buying such advice would well outweigh the additional cost, not everyone will or can pay this.

Also, financial planners will need to invest much time, effort and money in ensuring that they are familiar with the reforms' details and implications. This extra investment will impose a heavier burden on our own 'small business' members and might also increase fees. In turn, this might:

- make existing and potential clients less likely to seek the professional advice they need
- damage financial planners' public image – through no fault of their own – as they increase fees to meet the additional obligations.

[8] When he spoke at the 14.5.04 Insolvency Trustee Service Australia's 5th National Bankruptcy Congress in Melbourne. (Note: Bolding is our emphasis.)

6. An alternative approach to reform

There are long-standing processes contained in the *Bankruptcy Act* 1966 (Cwlth) that facilitate a creditor's access to the assets of a third party where a person who later becomes bankrupt makes a disposition of property with the intention to defraud creditors.

Also, under the present system, a trustee in bankruptcy can seek orders setting aside dispositions of property made within two years or, if at the time of the transfer the bankrupt was insolvent, 2-5 years before the commencement of the bankruptcy.

In the case of the NSW barristers, we understand that the *Bankruptcy Act* was not seen as deficient. Rather, it was the fact that the *Family Law Act* 1975 (Cwlth) was found to override the former Act. In particular, the Financial Agreements created pursuant to the *Family Law Act*, and the assets referred to in these Financial Agreements, were deemed 'untouchable' by the relevant trustee in bankruptcy.

As part of the proposed reforms, Financial Agreements can no longer be made except in the event of genuine separation. Additionally, for any property settlement made under the *Family Law Act*, a trustee in bankruptcy's claims can be taken into account.

The FPA supports these measures, but questions why the reforms were not restricted to the above resolution of the conflict between family law and bankruptcy law, given that specific inadequacies in the *Bankruptcy Act* itself have not been identified with precision.

7. Summary

1. The FPA supports the pursuit of those unscrupulous few who manipulate and abuse the present bankruptcy system, thereby allowing them to continue 'living the high life' while evading their taxation obligations.

2. However, if the Draft Bill is enacted in its present form, there will be some unintended negative consequences, and some of these will be serious.

3. These consequences could be avoided if the proposed reforms were reviewed and restricted to resolving the conflict between family law and bankruptcy law.

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