CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

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Mr James Mason
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By e-mail: phoenixing@treasury.gov.au

Dear Mr Mason

# Combatting illegal phoenixing

Thank you for the opportunity given to Chartered Accountants Australia and New Zealand (Chartered Accountants) to provide a submission regarding the paper entitled “Combatting illegal phoenixing”.

## Executive summary

From discussions with Treasury it is understood that there are tight timeframes regarding this consultation and that feedback regarding whether the proposals will be ineffective or highly effective on a scale of one to ten is highly important. To assist in the consultation process we have noted below our ratings (based on your scaling with 10 being the most effective).

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[1] Security deposits will be discussed in a supplementary submission

Chartered Accountants is of the opinion that prevention is better than cure, and that several other initiatives which are not canvassed in the paper would greatly assist in preventing phoenix operations. These initiatives include:

- implementation of a director identification number, which is mentioned but not elaborated on in the paper and in the Minister for Revenue's media release dated 12 September 2017;
- integration of the government's business registries with real time information and online search facilities which is gradually being embedded in business software; and
- action on disreputable advisors.

It is acknowledged that these proposals depend for their effectiveness on digital identity data, modernisation of business registers and to a limited extent the beneficial ownership register, all of which, the government has or is about to consult on. We encourage the government to pursue these initiatives and develop an integrated policy response.

Chartered Accountants also encourages the relevant regulatory agencies to use their existing powers (including those under the Crimes (Taxation Offences) Act 1980 to prosecute phoenix operators.

## Phoenix hotline

### Who to call?

The underlying issues in relation to the existing phoenix hotline are not obvious from the paper. In a Google search of 'report phoenix in Australia', the search engine generates, at the fifth item, a link to the ATO website that has a phoenix hotline. The sixth item is a link to an ASIC website that then takes you through to the ATO web site. Having multiple entry points to report phoenix operations that then refer you to the one ATO web site makes it easy to report phoenix operations and to ensure the appropriate officials are available to talk to those who are concerned about specific instances.

From discussions with Treasury we understand that there are also State-based phoenix hotlines which do not link to the central ATO hotline and have a different set of scripted questions to those used by the ATO. As a result, some reports of phoenix activity may not reach the relevant Federal authorities which have the power to act against phoenix operators or the information provided may not be sufficient to match information held by the Federal Government.

### Centralised contact point and information sharing

Chartered Accountants would strongly encourage the Government to liaise with the Council of Australian Governments (COAG) to co-ordinate their response to phoenix operations by linking their web sites that have a phoenix reporting functionality to that of the ATO so that one standard set of scripted questions can be used and acted upon. The ATO would also share insights with relevant State and Territory agencies. This could be included as part of the National Business Simplification Initiative which has already used a similar methodology in relation to business registrations.

### Are existing arrangements working satisfactorily?

On the assumption that information received by the ATO is being effectively shared between the relevant government agencies that can take action against phoenix operators, it would appear appropriate for the ATO to continue to operate the phoenix hotline.

### Does the Australian community have an adequate understanding of phoenixing?

To ensure that the hotline is effective, there should be a public educational campaign to help citizens identify and understand the indicators of potential phoenix activity.

Phoenix operators affect people in many different ways. Employees will probably notice the non-payment of superannuation or wages, creditors will have non-payment of debts, and competitors may notice pricing that is unrealistic unless tax is being avoided. If better public awareness increased the real time intelligence available to agencies this could assist in the identification of phoenix operators and speedier administrative action.

## A new phoenix offence

The paper acknowledges that currently there is no specific offence for illegal phoenix activity as it is difficult to distinguish between legal business rescues and illegal phoenix operations.

The paper proposes to create a phoenix offence by amending the Corporations Act to specifically prohibit the transfer of property from Company A to Company B if the main purpose of the transfer was to prevent, hinder or delay the proceeds of that property becoming available for division among the first company's creditors. This purpose will be deemed to exist if it can be reasonably inferred from all the circumstances that, at the time of the transfer, the transferor was or was about to become insolvent. A defence would be that there was payment for the asset at full going concern market value (which would also need to include some fair value for intellectual property, business names, domain names, telephone numbers and customer databases etc) and the transferee did not know, or be inferred to know, that the transferor was insolvent and that the transferor made the transfer for the purpose of defeating creditors.

Contravention of this proposed provision will result in the transfer being void against a liquidator, and create a right in creditors and liquidators to sue for compensation from not only those who engaged in the conduct but also those who are knowingly involved[2].

There are already a number of provisions in the Corporations Act which claw back assets. Section 588FE of the Corporations Act lists the types of transactions which are voidable, and thus can be clawed back. They include:

- An insolvent transaction – see Section 588FC of the Corporations Act;
- An uncommercial transaction – see Section 588FB of the Corporations Act;
- An unfair preference – see Section 588FA of the Corporations Act;
- An unfair loan – see section 588FD of the Corporations Act
- An unreasonable director related transaction – see section 558FDA of the Corporations Act

It is not clear how the proposed provision will be substantially different to the existing provisions. Nor is it clear how these additional laws will affect phoenix operators and how legitimate business restructures (as opposed to illegal phoenix operations) will be distinguished.

If the issue is that there is too high a burden of proof then perhaps broadening the range of sanctions to include administrative penalties with lower, reasonable inference tests might be useful. However, until greater details are available it is difficult to comment. We are happy to engage with you in the public interest to work on possible detail and utilising our members' experience as insolvency practitioners.

The paucity of prosecutions under the existing law does not bode well for any new law. It may be worthwhile considering preventing known phoenix operators from becoming active in the first place, perhaps with public "naming " for those who have unquestionably been involved in phoenixing activity. Providing the regulatory agencies with both the mandate and the additional funding needed to pursue cases should also be considered.

**Are regulators using their in-house intelligence effectively?**

Treasury's consultation paper entitled "Reforms to address corporate misuse of the FEG scheme" noted that:

> "Of the more than 1300 directors involved in multiple FEG [Fair Entitlement Guarantee] cases, more than 950 were involved with one or more companies where FEG or GEERS [General Employee Entitlements and Redundancy Scheme] was advanced and no return was obtained

[2] Section 79 Corporations Act. "A person is involved in a contravention if, and only if, the person:
  a has aided, abetted, counselled or procured the contravention; or
  b has induced, whether by threats or promises or otherwise, the contravention; or
  c has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or
  d has conspired with others to effect the contravention."

> through the insolvency process. Further of the 950 directors, more than 600 of those directors were involved in two or more cases where FEG or GEERS was advanced and no return was realised in the insolvency process."[3]

It seems clear that ASIC knows who is likely to be a potential phoenix operator: there just needs to be better warnings in the system about them and more prosecutions. As noted in our submission regarding the modernisation of ASIC's business registers, having the public being able to search at no cost, a name and find all companies associated with that name (both current and historic) and to be able to ascertain the status of the company and its history of Corporate law offences would greatly benefit those trying to ascertain the trustworthiness of the third party that they are intending to interact with.

### Making existing offences 'designated phoenix offences'

The paper also proposes that failure to maintain adequate books and records in accordance with the Corporations Act provisions, and failure to provide such books and records to an insolvency practitioner in a formal insolvency be deemed to be designated phoenix offences and thus make a director a 'high risk phoenix operator' (see discussion below under 'overview of taxation aspects').

Although a worthy proposal, Chartered Accountants would submit that there is currently inadequate enforcement of existing provisions. More regulation in this area is not necessarily going to change things without due consideration of why the current regime is not working as effectively as it should.

However we would support a legislative provision that requires asset transfers to be fully documented in formal written agreement (like land sales) to be legally valid thus making a liquidator's job easier to find assets.

### Directorships

This paper proposes the following reforms to directorships:

- moving the onus of reporting director resignations from the company to the resigning director
- continuing to allow 28 days for lodgement of the director resignation, but if longer than 28 days is taken the director's resignation is not effective until the resignation has been lodged
- preventing a sole director from resigning without finding first a replacement director or winding up the company's affairs.

Our members often report abuse of the director resignation provisions. For example, a member who was recently appointed as a court liquidator found that a document was lodged and accepted by ASIC in March 2017 which had the effect of back dating the resignation of its sole director to 2010 even though the said director was signing documents to obtain finance in 2014 as a director of the company.

Chartered Accountants fully supports these proposals. Given the developments in communication technology, it is suggested that the 28 day lodgement period be reduced to a period consistent with other new legislation. This should be implemented as a matter of urgency.

### Voting restrictions

The paper proposes that an external administrator be required to disregard related entities which are creditors in relation to votes received on a resolution to remove and replace an external administrator.

Our members have advised that it is not unusual to encounter related parties buying debt at heavily discounted amounts to enable the related party to have voting entitlements at the face value of the debt. Excluding all related creditors may not be appropriate in certain situations (for example warring families). It may be worthwhile considering capping the voting rights of related creditors, for example to 25%.

[3] Section 7 of https://treasury.gov.au/consultation/reforms-to-address-corporate-misuse-of-the-feg-scheme/

This rule should operate regardless of the size or type of entity.

## Overview of the taxation aspects

Most of the taxation aspects of this paper involve distinguishing likely phoenix operators from other taxpayers and then imposing tighter requirements or higher penalties upon the likely phoenix operators. The paper proposes to distinguish the likely phoenix operators by adopting a two- step process, namely:

1. Designating them as a “Higher Risk Entity” (HRE).
2. Allowing the Commissioner of Taxation to declare that a HRE is also a “high risk phoenix operator” (HRPO).

### HRE

It is proposed that an individual will be designated as a HRE if:

- They have been previously been disqualified from managing a corporation; or
- They have been an officer of two companies which have entered liquidation in the previous seven years (or other appropriate period) **and** where:
    - There has been a failure to provide adequate books and records to an insolvency practitioner; or
    - An insolvency practitioner has lodged a report under section 533(1) of the Corporations Act in respect of the company; or
- They have been found to have committed a phoenix offence (if it is introduced) or subject of promotor penalty sanctions;
- They are an officer of an entity which has a poor regulatory compliance history that is consistent with suspected illegal phoenix activity and they are provided with notice of their designation by the ATO (or other appropriate regulator, such as ASIC). The consultation paper notes that this may include involvement in past liquidations where claims have been made to the Fair Entitlements Guarantee Scheme, repeated failure to lodge required forms and returns in the lead up to liquidations, or repeated failure to keep records relating to the transfer of assets to related entities.

The above criteria , subject to our comments about section 533 notices below, appears a reasonable way in which to impose a higher ‘watch’ by the ATO without triggering adverse consequences for the individual/entity. This type of classification may even be helpful, for small to medium business operators who are struggling to understand their business obligations as it may allow the ATO to provide more timely reminders and follow up actions to assist them keep their business on track.

Section 533 of the Corporations Act requires an insolvency practitioner to lodge a notice if dividend income of more than 50 cents in a dollar is NOT being paid in the liquidation. Our insolvency members have advised us that 99% of insolvencies have section 533 notices issued in relation to them and that this is not necessarily due to inappropriate behaviour. Many businesses can fail for reasons outside of their immediate control, for example failure of a major customer or supplier, or suffer from simply growing too fast.

It may be worthwhile considering adding a requirement to lodge a notice if the insolvency practitioner has identified that there have been breaches of director’s duties and/or phoenix activity. This may involve modifying the format of the section 533 notice.

### HRPO

It is proposed that greater restrictions will apply where a HRE is designated to be a HRPO. The HRPO designation would apply to the individual, and where that individual is an officer of a company it can be, at the discretion of the Commissioner, extended to the company itself.

The consultation paper does not specify what criteria the Commissioner of Taxation would consider before exercising a power to declare a HRE to be a HRPO. Rather, it says that it would be decided on a “case by case basis taking into account the surrounding circumstances”.

Being designated as a HRPO potentially means that:

- A liquidator will be appointed using the cab rank system – that is the HRPO cannot appoint a liquidator of their choice.
- The 21 day waiting period for a director penalty notice does not apply which means that the ATO can immediately commence proceedings to compel the directors to pay the penalty.
- The ATO will be able to retain a refund that would otherwise have been refunded to the HRPO in circumstances where the HRPO has an overdue lodgement or notification capable of affecting a tax liability.

We understand that those involved in phoenix activity exploit existing legislative provisions, are adept at circumventing black letter law, and that the Commissioner of Taxation would be required to provide notification of a HRPO decision that can be subject to review. Notwithstanding this, Chartered Accountants is of the view that some high level criteria for consideration by the Commissioner should be specified.

Chartered Accountants has already received several complaints from members about the approach currently adopted by the ATO regarding suspected phoenix participants. The current ATO approach appears to be to internally identify a potential phoenix pattern (for example where a first time investor makes separate investments in two start-up businesses which did not do well) and then send letters to not only the suspected phoenix operator but also to their spouse and third party business partners (a scatter gun approach). These letters state that Entity X or Individual X has been identified as part of a phoenix arrangement and that unless action is taken immediately they will become personally liable for the company's debts. Apart from potential breaches of privacy and loss of reputation, the current approach raises issues regarding the due processes adopted by the ATO in identifying and classifying potential phoenix operators.

In the cases that have been brought to our attention, the ATO letters have been sent to people who have suffered substantial business losses as a result of speculative business investments or operated in an industry that was of concern to the ATO, but they have not been part of a phoenix operation.

This indicates to us that, whilst not detracting from the desirable proactive ATO action:

- some criteria and processes should be established around whether or not HRBO status should be established
- the ATO's standard letters for suspected phoenix cases should be reviewed to reduce the risk of 'false positives', and
- the ATO should have a review or monitoring team (if it does not already do so) tracking the experience of these activities to continuously improve and fine tune the selection and its effectiveness/ Members of this team should have current, practical experience (that is comprise analysts in the field, rather than desk-bound data analysts).

Given the significant consequences of being deemed a HRPO, there should be review processes around the Commissioner's decision. This submission does not explore this aspect but Chartered Accountants is interested in liaising with Treasury about the proposed review process.

*Director Penalty Notices*

The paper proposes two changes to director penalty notices (DPNs), namely:

- removing the 21 day waiting period for those directors identified as HRPOs, and
- extending DPNs to GST (regardless of whether or not the director is a HRPO).

Chartered Accountants supports the removal of the 21 day waiting period for those directors identified as HRPOs provided that there is greater clarity about when and how a director will be deemed to be a HRPO (see above).

Extending DPNs to GST is not a new idea. It was originally proposed by Treasury in 2009 but rejected by the then Government. The Inspector General of Taxation has also recently considered this issue and rejected it on the basis that such an extension was incompatible with the removal of government priority in relation to tax debts.

Our members have mixed views on this.

Our insolvency practitioner members are generally supportive of the extension of the DPN to GST.

Our indirect tax practitioner members have more mixed views – some are supportive of the extension as it may reduce the proliferation of more anti-avoidance legislation, whilst others are of the view that the Commissioner of Taxation is already the first to know when the payment of GST is an issue and has established powers.

It is noted that this paper also proposes that the ATO have the ability to retain refunds where an entity is classified as a HRPO. If this proposal succeeds then the need to have a DPN extend to GST (which affects all directors but just HRPO) is diminished.

*Power for ATO to retain refunds*

It is acknowledged that phoenix operators are known to arrange the timing of their lodgements to ensure that they receive their refunds as soon as possible but delay or avoid lodgement of any returns which are expected to result in a liability.

The biggest design flaw which has emerged with the PAYG instalment system is the delay which occurs in actually issuing a PAYG instalment rate to the taxpayer, thus triggering the obligation to pay instalments.

In practice, PAYG instalments only commence after the first income tax is lodged, processed and an instalment rate issued. Because of tax agent lodgement program arrangements, lodgement can occur as much as 18 months after business operations have commenced. Upon initial assessment of this first tax return, the taxpayer is then confronted with two tax debt obligations:

- the assessment of income tax for the first year, and
- (typically) one quarter of the total PAYG instalment owing for Income Year 2 (which is typically based on the first year's tax liability).

Significant hardship can arise for poorly advised taxpayers who have not set aside sufficient tax funds. Worse still is the opportunity this presents to phoenix operators to claim GST credits but not become liable for income tax until a much later point in time.

Chartered Accountants has for some time called for a review of the PAYG instalment system due to the large time lag between the derivation of income and the payment of income tax[4]. It is time to revisit the design of our 17 year PAYG instalment system – in particular when instalment rates are issued, how the instalment rate is calculated, and the timing of remittance. We also point Treasury to recent reforms to the equivalent PAYE system in New Zealand, such as the introduction of the accounting income method.

## Promotor penalties

The paper proposes three options to reform the Promoter Penalty Laws in Division 290 of Schedule 1 to the Taxation Administration Act 1953 (TAA):

1. Broadening the definition of what constitutes a 'tax exploitation scheme';
2. Adding a new limb to section 290-50 of Schedule 1 to the TAA; and
3. Creating a new provision outside of the existing promoter penalty laws similar to the provision on the promotion of illegal early release of superannuation benefits.

We are of the view that any changes to the promoter penalty laws in line with Option 1 or Option 2 will be difficult to implement and go beyond the underlying purpose of these measurers.

[4] See our submission to the Inspector General of Taxation's review into the Pay-As-You-Go instalment system **View Submission >**

Firstly, ATO sources tell us that their chief concern with the current laws is in the definition of a "promoter".

Secondly, expanding the definition of 'tax exploitation scheme' to apply to activities designed to avoid taxation obligations may be difficult to implement.

Currently, the meaning of 'tax exploitation scheme' has a 'sole or dominant purpose' test of enabling an entity to get a scheme benefit from the scheme. If the sole or dominant purpose test, or even a 'main purpose' test was applied in relation to 'activities designed to avoid tax obligations', the definition could be ineffective as avoiding tax obligations is but one of many obligations that are avoided in undertaking phoenix activities.

If the purpose test was relaxed so that avoiding tax obligations was one of the purposes, this could result in advisers involved in legitimate business restructuring and rescue efforts being caught.

Thirdly, adding a new limb to the test to deal with illegal phoenix activity will be an overreach of the promoter penalty laws. The object of Division 290 (section 290-5 of Schedule 1 to the TAA) is to deter the promotion of tax avoidance schemes and tax evasion schemes. These schemes involve adjusting tax liabilities and credits of a taxpayer. To add a limb so that an entity must not engage in conduct that results in that or another entity being a facilitator of "illegal phoenix activity" is extending Division 290 beyond its underlying purpose.

In view of the above, Option 3 appears to us to be the most effective option proposed. The difficulty with implementing this option however will be where to draw the line so that legitimate insolvency advisers are not caught. It seems Option 3 involves a provision along the lines of the following:

> "A person must not promote a scheme that has resulted, or is likely to result in [the proposed Phoenix Offence] the transfer of property from one company to another where the main purpose of the transfer is to prevent, hinder or delay the payment of existing or expected liabilities including tax liabilities, employee entitlements and debts to creditors."

The work of advisers in the legitimate business restructuring and turn-around industry could fall within the broad scope of Option 3. To distinguish legitimate advisers, the new provision should be narrowly targeted at advisers who are linked with high risk phoenix operators and provide more involvement than merely providing advice. Again, we see merit in liaising with insolvency specialists to further develop the criteria to be used and are happy to assist.

We also note that illegal phoenix activity is the misuse of the corporate form to avoid the payment of liabilities, including tax liabilities (per the paper). It is our view therefore that the root of the 'bad behaviour' is the misuse of the corporate form and so we see greater potential in stopping the promotion/ facilitation in the first place.

## Cab rank appointment of liquidators

The paper proposes two options. The first option is that a cab rank rule would apply only to a company where an officer of the company is a HRPO. The second option is to establish a government liquidator to conduct a streamlined external administration of small-to-medium size enterprises with the option to appoint a private registered liquidator if circumstances warranted it.

Chartered Accountants prefers the first option as this can be seen as an extension of the 'zombie company' processes whereby ASIC has the power to appoint a liquidator and agree fees when a company has no directors but employee entitlements.

Under either option there is a risk that:

- the appointed liquidator may lack the appropriate industry skills/experience – this may need to be addressed by having different cab ranks for different industries, and
- pre-insolvency advisors may encourage voluntary administrations rather than external administration to avoid such an appointment

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## About Chartered Accountants

Appendix one contains information about Chartered Accountants Australia and New Zealand.

If you wish to discuss our comments please contact me on [redacted] or [redacted].

Yours sincerely

**Michael Croker**
**Tax Leader Australia**
**Chartered Accountants Australia and New Zealand**

## Appendix One: About Chartered Accountants Australia and New Zealand

Chartered Accountants Australia and New Zealand is a professional body comprised of over 117,000 diverse, talented and financially astute members who utilise their skills every day to make a difference for businesses the world over.

Members are known for their professional integrity, principled judgment, financial discipline and a forward-looking approach to business which contributes to the prosperity of our nations.

We focus on the education and lifelong learning of our members, and engage in advocacy and thought leadership in areas of public interest that impact the economy and domestic and international markets.

We are a member of the International Federation of Accountants, and are connected globally through the 800,000-strong Global Accounting Alliance and Chartered Accountants Worldwide which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries.

We also have a strategic alliance with the Association of Chartered Certified Accountants. The alliance represents 788,000 current and next generation accounting professionals across 181 countries and is one of the largest accounting alliances in the world providing the full range of accounting qualifications to students and business.