Law Council
OF AUSTRALIA

Business Law Section

31 October 2017

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

By email: phoenixing@treasury.gov.au

Dear Mr Mason,

Combatting Illegal Phoenix Consultation Paper

Please find enclosed two submissions in response to the Treasury's Combatting Illegal Phoenix Consultation Paper released on 28 September 2017. The submissions have been prepared by the Insolvency & Reconstruction Law Committee (**IRL Committee**) and the Taxation Law Committee (**the Tax Committee**) of the Business Law Section of the Law Council of Australia respectively.

The Committees are two of the fifteen specialist committees and one working party established within the Business Law Section to offer technical advice on different areas of law affecting business. Each of these Committees approach issues of law reform and practice from a different perspective, which reflects their respective primary focus.

In this instance, whilst the two Committees agree on some issues, the IRL Committee's submission has sought to respond to all the questions raised in the Consultation Paper whereas the Tax Committee has focussed only on the tax proposals in the Consultation Paper. There are some differences between the views expressed. For example:

- regarding promoter penalties the IRL Committee concludes that there is insufficient information contained in the proposal, whereas the Tax Committee is of the view that it is not an appropriate measure.
- regarding expanding director penalty notices (**DPNs**) to GST, the IRL Committee considers that this is a worthy idea whereas the Tax Committee had mixed views about this proposal.
- on the issues of security deposits the IRL Committee support this if only applied to high-risk phoenix operators (HPROs) whereas the Tax Committee considered it is inappropriate to extend the garnishee power to security deposits.
- the IRL Committee were generally not supportive of removing the 21 day period for DPNs, however the Tax Committee considered such a change, while appropriate for directors already designated as HRPOs, should not apply to directors more generally.

Thank you for the opportunity to provide these submissions.

Should you require further information, please contact in the first instance Victoria Butler, Chair of the Insolvency and Reconstruction Committee [redacted] or Adrian Varrasso Chair of the Taxation Law Committee [redacted]

Yours sincerely,

Teresa Dyson, Chair

Business Law Section

Insolvency & Reconstruction Law Committee of the Business Law Section comments

1. The Insolvency and Reconstruction Law Committee (**IRL Committee**) of the Business Law Section of the Law Council of Australia welcomes the opportunity to provide comments on Treasury's Consultation Paper on 'Combatting Illegal Phoenixing'.

2. Rather than respond to the individual questions asked in the paper, the IRL Committee provides the following comments for Treasury's consideration.

1. General comments

3. The consultation paper asks respondents to rank the various proposals based on an effectiveness measure of between 1 and 10. The IRL Committee provides a ranking where possible but does so in the knowledge that:

    a. more detail on the proposals is needed; and

    b. the effectiveness of the proposals should be taken as a whole together with the current measures in place (rather than as stand-alone options).

4. Importantly, the ranking is solely for the effectiveness of the proposal for deterring and disrupting illegal phoenix activity. The ranking does not take into account the possible adverse effects on genuine restructuring efforts. Given the Australian Government's efforts to encourage innovation (recently seen through the insolvent trading safe harbour and ipso facto clause reforms), the benefits of any new measures to deal with illegal phoenix activity must be weighed against any inadvertent adverse effects on genuine rescues.

2. A phoenix hotline

5. The IRL Committee considers that a phoenix hotline may be of value. It suggests that:

    (a) Reports should also be able to be made via web form submission on a dedicated website, for instance "www.phoenixtaskforce.gov.au/reports".
    (b) Consideration should be given to including a pro-forma paper reporting form with the first report to creditors, accompanied by an invitation to return it to the liquidator to:
        i. review and consider as part of his or her duties as liquidator; and
        ii. pass on to the Taskforce or relevant regulator.

    (c) In an effort to reduce the number of time-wasting reports, both the web form and the paper reporting form should attempt to educate possible complainants by describing illegal phoenix activity, and pointing out that not all pre- appointment transfers to related entities are unlawful.

6. However, in terms of transparency, it would not be fair to report publicly that someone has made an allegation of illegal phoenix behaviour. There should be no public reporting of allegations or complaints, as distinct from findings, as such reporting may unfairly impact NewCo's trading activities and act as an unnecessary impediment or disincentive to legitimate business rescue. Unfortunately, people are seemingly ready

to accept emphatic assertions as fact, without requiring evidence or independent review.

7. The phoenix hotline proposal should also consider whistleblower protections and rewards, as well as clear confidentiality provisions, so as to create a safe and effective motivation for reporting possible phoenix activities. The IRL Committee notes the release of the Exposure Draft of the Treasury Laws Amendment (Whistleblowers) Bill on 23rd October 2017, although questions why the consultation period for this legislation, closing on 3rd November 2017, is so short.

Rating: 7

3. A phoenixing offence

8. There were mixed views about this proposal among IRL Committee members.

9. The object of Part 5.3A is to maximise the "chances of a company or as much as possible of its business continuing in existence". If the business is to continue in existence, it is often necessary to put it into a new entity. This means treading a very fine line with whether or not "the main purpose…was to prevent, hinder or delay the process of that property becoming available for division among the first company's creditors".[1] In the event that a proposal to create a phoenixing offence goes ahead, a mechanism for an independent appraisal and approval of "pre-packs" will need to be established at the same time so that directors can pursue “honest business rescue” and voluntary administrators can undertake their work without fear of later prosecution. We also consider the “main purpose” test to be inherently difficult to apply and easy to argue about, encouraging spurious defences and thereby increasing prosecution costs. It would need to be replaced with something objective.

10. Another difficulty with the phoenix offence as proposed is that it does not deal with a sale agreement that discloses consideration to the value of the property to be transferred (often based on a valuation the parties have obtained), where the consideration is “paid” by the purchaser assuming liabilities of the vendor company. Where this relates to employee entitlements it may fit within the bounds of normal commercial transactions and be a desirable state of affairs. Employees as priority creditors will be paid ahead of unsecured creditors and their payment will save the government a Fair Entitlements Guarantee (**FEG**) advance.

11. There needs to be great care taken where the parties rely on a valuation. A proper valuation would place a market value on the business being transferred, not just on hard assets such as plant and equipment. Further, it should not be assumed that just because a business makes a loss it has no value over and above the value of the hard assets. The issue can be tested by asking whether the director(s) would have “sold” the business for the same price to an unrelated entity.

12. However, where the purchase price is “paid” by the assumption of unsecured creditor liabilities, the transaction can have the effect of preferring the creditors whose debts are assumed to the detriment of the creditors remaining with no assets for distribution to meet their claims, despite the fact that “market value” consideration has been paid by the purchaser. This might entail amendments to the preference provisions to

[1] Consultation Paper, 8-9.

discourage this behaviour more clearly and to reduce the impact on the creditors who are not assumed by the purchaser.

13. There were also concerns expressed about the reversal of the onus of proof. The consultation paper states that ‘the main purpose in making the transfer will be taken to be the prescribed purpose, "if it can reasonably be inferred from all the circumstances that, at the time of the transfer, the transferor was, or was about to become, insolvent"’. The IRL Committee does not believe it is appropriate for liquidators to be able to request the Australian Securities and Investments Commission (**ASIC**) to issue a notice, in the same way that an Official Receiver may send a notice to a person who it considers has received property in contravention of s 120 - 122 of the *Bankruptcy Act 1966* (Cth).

14. In the event that a notice system is introduced, only ASIC should have the ability to initiate the notice, on receipt of information from others such as the FEG Recovery Program. The notices might create a statutory charge. Alternatively, failure to comply might result in a deemed trust, allowing the liquidator to make application to the court to be appointed as the receiver and manager of the trust property.

15. Onus of proof would then lie on the recipient of the property to establish that the transaction was not uncommercial, and personal liability might lie on any director of the recipient company who has not taken reasonable steps to cause the company to comply with the notice. In terms of safeguards, there should be “reasonable steps”-type defences, and there should be a right of internal review within ASIC and a further right of judicial review, although the notice should remain extant until overturned. Of course, the biggest difficulty here is that ASIC has to bring the action where people ignore or flout the notice.

16. The main benefits of a phoenix offence relate to signalling, general deterrence and denunciation of this conduct. Greater stigma would attach to the conduct if there were a specific offence for it. It would also be easier for advisors, advertising campaigns, and other education materials to demonstrate to directors that certain phoenix behaviour is illegal, and to do so in a way that will have impact, for instance pointing out that ‘penalties include imprisonment for up to five years’. The same applies to warnings to pre-insolvency advisors, lawyers and accountants about the risk of accessorial criminal liability.

17. As an offence, directors may invoke the privilege against self-incrimination to refuse to answer questions, assist the liquidator, produce books and records etc. Appropriate drafting could remove this risk as has occurred with the public examination provisions. Nonetheless, the general view is that the problem isn’t the absence of a phoenixing offence but rather the lack of enforcement of existing breaches that is the problem. As one person put it, ‘if the crime rate is high, then you don’t reduce it by adding another crime.’ If actions are not brought by ASIC, the prosecution statistics – or lack of them – will invite further criticism of ASIC and will send the message to perpetrators that they can act with impunity.

Rating: 5

4. Remedies

18. The IRL Committee notes that the Government is considering whether or not both liquidators and ASIC should be able to claw back assets and whether or not

liquidators, ASIC and creditors should be able to pursue compensation.2 If this proposal is implemented with respect to creditors' rights to seek compensation, there will need to be a mechanism equivalent to *Corporations Act 2001* (Cth) s558R - 558U. These provisions require liquidator or court approval for a creditor action with respect to insolvent trading.

19. The policy underpinning the need for approval is that there might be double recovery by the creditor in the event that both liquidator and creditor take action. There can also be unnecessary and costly duplication of actions. Moreover, some creditors might unreasonably take action, with the result that some directors engaging in legitimate business rescues could be threatened unfairly with litigation.

20. Reformed legislation would also need to make clear the respective rights and obligations of liquidators and ASIC if ASIC is to be involved in any attempt to claw back assets or pursuing compensation. There are real conflict issues at the present time when a liquidator is seeking to pursue civil remedies and ASIC is seeking to prosecute directors. For example, in In the matter of Australian Property Custodian Holdings Limited, the liquidators commenced a civil action to recover over $100 million compensation which had to be placed on hold pending finalisation of criminal proceedings subsequently commenced by ASIC against the former directors including Bill Lewski and Michael Wooldridge. ASIC was successful in the first instance in obtaining penalties of up to $230,000 and disqualification orders but that was successfully appealed. As a consequence, the civil proceedings trial will not take place until the first half of 2018, some eight years after the collapse of the Prime Trust in 2010.

21. Actions against accessories would be an important part of a phoenix offence, and the provision should expressly include liability for knowing involvement, as the existing directors' duties s 181 – 183 currently do. There is no need to change the present tests for accessory liability; rather the provisions should simply be utilised.

Rating: 5

5. Designating breaches of existing provisions as phoenix offences

22. The IRL Committee understands that these existing provisions, which capture non-phoenix circumstances as well as phoenix circumstances, are designed to trigger the special status of High Risk Entity (**HRE**), as explained at page 25 of the consultation paper. At present, page 25 does not appear to include a 'designated existing provision' as the trigger, just 'a phoenix offence if one is introduced'. In addition, the section used as an example of a possible designated existing offence – s 286 – also appears independently to be a partial basis of an HRE designation. The HRE or high-risk phoenix operator (**HRPO**) idea is discussed further below.

23. If existing provisions are to be designated as 'phoenix offences', it makes sense to broaden it well beyond actual offences. For example, uncommercial transaction recoveries in previous company liquidations is 'a sign' that should be taken into account in deciding whether this person in this liquidation should be considered a HRE. Breaches of civil penalty provisions – the directors' duties, insolvent trading, and related party transactions – are all highly relevant.

Rating: 5

[2] Ibid 11.

6. Addressing issues with directorships

24. There was a split in views on the proposal regarding the change in director notice. Some thought it was appropriate but others again were concerned about the reversal of onus of proof. A practical issue was raised – while it is possible for the outgoing director to lodge their own form, there was some experience that ASIC did not accept the director's form in the first instance.

25. There was opposition to the proposal to limit a director's ability to resign from office. This seems philosophically opposed to the current regime which is directed towards work outs in appropriate circumstances and otherwise taking appropriate steps when this is not possible. This proposal instead seems to encourage "early jumping" to avoid being the one holding the baby. If there are two directors in a stalemate, so that they can't agree on appointment of a voluntary administrator, then it is proper and appropriate to resign and there shouldn't be a fetter on this. There is a bundle of duties and obligations that comes with being a director and if a director can't perform them, the director should resign.

26. The question about sole directors resigning without appointing a liquidator or deregistering the company is misconceived as a director can't appoint a liquidator; liquidators are appointed either by creditors or members.

27. Further, it is not clear how the proposed reform would address Treasury's stated concern. If the former director is in fact acting as a director, that person will be deemed to be a de facto director in accordance with the expanded definition of director under s 9 of the Act. Resignation makes no difference.

28. Requiring the director to have the obligation to lodge their own notice, and to do so promptly (within 7 or 14 days of the actual resignation) is not an unreasonable burden. It would not need to be "enforced" per se. If the statute created a presumption, then such person who might wish to take action against the director concerned (ASIC or the liquidator) could rely on the presumption in taking that action.

29. The resignation/continued liability issue and the abandonment issue are in fact separate. The first requires enforcement. The second can be addressed administratively. ASIC should look more closely at what it can do to keep track of people who abandon companies and see whether they should be subject to disqualification.

Rating: 5

7. Restrictions on voting rights

30. The existing powers of creditors to seek the replacement of an administrator are sufficient.

31. There is a real risk that this will unfairly impact legitimate related party creditors (who in many instances are the largest group of creditors) from exercising their rights as creditors. It is also naive to think that related party creditors are the only creditors to exercise their rights with the risk of litigation in mind. For example, trade creditors may want to remove a liquidator who is pursuing them vigorously for unfair preferences. Is this to be unacceptable too? If related party creditors are the biggest creditor block, it is difficult to maintain that they should not have a say in the outcome of the vote.

32. In any event, employees should not be treated as related creditors in relation to any restrictions on voting rights in respect of claims for employee entitlements. It is not their fault (generally) that the company failed and they have a legitimate interest, not only as creditors but also as prospective employees of any restructured business, in the outcome of the winding-up.

33. An alternative to deal with the current situation outlined in the consultation paper would be to require all creditors to submit their claims 24 hours prior to the meeting unless they receive the written consent of the administrator to lodge a claim after this time. While this would not be guaranteed that no insolvency practitioner abuses this system, it would be much easier for ASIC to track such instances and does not run the risk of genuine related party creditors being denied a voice at the meeting. The other major reform required in this space is the adoption of the rule used in bankruptcy that creditor claims that have been acquired can only be used to vote for the value paid by the party taking the assignment of the claim.

34. Another approach would be a requirement that liquidators permit the audio or video recording of creditors' meetings, and provision for such recordings to be admissible as evidence of what was said and done at the meeting. Transparency is a great deterrent against suspect behaviour out of the public eye.

35. There could also be a specific provision entitling ASIC to send a representative to attend any meeting of creditors as an observer.

Rating: 1

8. Promoter Penalties

36.

37. It is hard to comment on the risk of these provisions picking up legitimate advice without seeing the provisions and any proposed defences. We are concerned about the reverse onus implicit in Option 1, requiring advisors to prove by way of a defence that they were providing "mere advice for legitimate purposes". What exactly would this entail? Is everyone providing advice considered to be a 'promoter' until they prove otherwise? Or is there an initial requirement for the prosecution to establish promoter status (how?) and then the defence must be established by the promoter that they only provided "mere advice for legitimate purposes"?

38. Option 3 may be the best option, as it can be tailored to the activity that the government wants to prevent. Expanding existing definitions or adding new limbs to the test may lead to less precise outcomes. That said, it is very difficult to comment without seeking more detail on what is proposed. There is concern about civil and criminal penalties applying to those who are knowingly involved in illegal phoenix activity as it may fetter legal advisors being prepared to give full and frank advice in this area.

39. We have our doubts about a court order that an advisor submit a company liquidation approach to ASIC for its consideration. Does ASIC have the expertise to give an opinion? What is the timeframe? Who bears the extra costs involved? There are laws currently available to ASIC where it becomes aware of improper behaviour by directors and their advisors. ASIC needs to improve detection and bring enforcement actions.

Rating: Insufficient information about proposal to provide comment.

9. Extending DPNs to GST

40. The IRL Committee considers that this is a worthy idea, and it should apply to all directors, not just HRPOs.

41. Directors will be motivated to treat GST receipts (i.e. money paid in response to a mark-up for GST) as trust money and report and account for it punctiliously to the Australian Taxation Office (**ATO**). The case for GST director penalty notices (**DPNs**) is even stronger than for PAYG DPNs, because with PAYG the money may never have been there, but in the case of GST a customer has paid an extra 10% especially for the GST, so failure to account for it is essentially (albeit not legally) a form of misappropriation.

42. On the flip side, being yet another avenue to go behind the corporate veil, it may discourage entrepreneurship, particularly in the property sector.

43. It would be important to include some sort of protection for people who do not charge GST on something because of a genuine belief that they don't have to, and then discover – for instance as a result of an audit – that they have GST to pay. Such persons do not have the relevant guilty mindset to justify sticking them with personal liability for the GST that was neither collected from the customer nor remitted to the ATO.

44. However, DPNs are only useful if the directors have assets. It doesn't matter what the DPN covers if the company and its directors ensure that they own nothing. Perhaps a separate criminal offence on directors for unremitted GST might work.

Rating: 8

10. Security Deposits

45. Many business models are based on, and legitimately structured around, cash flow. This approach could severely disrupt the cash flow of subject businesses, potentially causing them to become insolvent when they would not have been insolvent if the business had not been required to put up security.

46. However, if the measure is only applied to HRPOs, and is applied judiciously in a way that is less likely to result in a cash flow pinch (for instance if it is applied only where the company has existing assets, such as a property development, over which it can offer security – rather than a requirement for a cash bond to be scraped together somehow), it becomes less objectionable.

47. Consideration should be given to making non-compliance with a security requirement a deemed insolvency event, akin to non-compliance with a statutory demand. That would permit the ATO to commence winding up proceedings against the taxpayer, during which the taxpayer would have the onus of positively establishing solvency.

Rating: 5

11. Targeting Higher Risk Entities

48. The consultation paper proposes two steps – first, automatic designation as an HRE if certain thresholds have been met, and second, the Commissioner's decision to declare an HRE to be an HRPO. Given the conditions under which HRE status is automatically conferred – previous disqualification, adverse liquidator reports, failure to provide books and records, commission of a phoenix offence, poor compliance history and like behaviour – the IRL Committee questions what further grounds will be required to take the person from the status of an HRE to an HRPO. These are not stated in the paper, only that the decision would be taken on a case by case basis taking into account the surrounding circumstances.

49. Because significant consequences flow from being an HRPO (but not an HRE) it is important that the criteria for HRPO status is clarified before any such proposal is developed further. Some relevant ones might include:

    (a) number of previous failures;
    (b) whether companies have similar names;
    (c) consideration paid wholly or partly by the assumption of liabilities; and
    (d) deferred payment terms without security.

50. However, HRPO status could well spell the end of the business. In particular, if the HRPO status were able legally to be disclosed to the company's tax agent and authorised ATO contact people, employees, and PPSA secured creditors (including ROT suppliers, factoring companies and bankers), it could be highly disruptive to the subject business. The concomitant risk is, of course, that the overenthusiastic use of such a power could destroy an otherwise good business.

51. If the Commissioner of Taxation were able to declare a company an HRPO, where the company has, or has recently had, directors and officers who are HRPOs, appropriate safeguards would need to be put in place to ensure that shareholders are able to identify whether or not a person is an HRPO before appointing that person to the board. Alternatively, they must be given an opportunity to avoid HRPO designation by sacking that person within, for example, 28 days after being notified of the ATO's intention to designate the company an HRPO.

52. At present, the register of banned directors is searchable online for free. The same could be done with HRPOs.

Rating: 5

12. Cab rank appointments

53. IRL Committee members have mixed views on this proposal. Some agree that it might have some benefits provided it is restricted to circumstances where a HRPO is, or has recently been an officer, and the appointee is funded to conduct the normal tasks imposed upon a liquidator.[3] A limited cab rank procedure could be appropriate in default of the relevant appointor selecting and obtaining a consent from a particular liquidator. However, even in circumstances such as these, cab-rank appointments can interfere with the proper operation of the market, such that the liquidator with the right experience may not be appointed.

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[3] Ibid 28.

54. The IRL Committee absolutely opposes all liquidation appointments being decided on a cab rank basis. It is important that directors and advisors who are acting appropriately still have the opportunity to select an insolvency practitioner who is appropriate for the role. A number of factors go into the selection outside geographical location, including expertise in the industry segment the company is trading in, size and the complexity of the appointment. It will be important that the cab rank system does not prevent legitimate consideration being given to who is best placed to undertake the appointment. Option 1 therefore seems like it would be a good balance, but will really only work if the designation of HRPO is used judiciously by the ATO.

55. Some members considered the cab rank idea – even a limited one – to have too many adverse consequences. These include:

    (a) people who should probably be appointing a liquidator being unwilling to “take a leap into the unknown” and delaying a formal winding up they might otherwise have been prepared to initiate;
    (b) costing additional money to administer;
    (c) result in liquidators being appointed who did not have optimal industry expertise; and
    (d) not be a complete solution to the identified evil, in that the cab rank liquidator could be removed and replaced by (director-friendly) creditors anyway.

56. Others suggest that while the cab rank idea might overcome the problems of ‘friendly liquidators’ in creditors’ voluntary liquidations, the same should not exist in voluntary administration. The appointee needs to form a view as to a number of specific types of potential claims and then publish a fairly detailed report.

57. Overcoming collusion issues in liquidations could be achieved through minor changes which could occur by way of, for example, there being a 7-day delay between the resolution to wind up (which would commence the relation back period) and the appointment of a liquidator taking effect. In the meantime, the regulator could nominate a liquidator from a panel, such as the panel already in place for ASIC initiated windings up. Alternatively, a “government liquidator” of some sort could serve in the short interim period, not unlike the AFSA practice of referring out estates which have assets in them to private trustees after initially taking the appointment.

58. Above all, the cab rank proposal if implemented would require a guarantee of adequate funding that would not require the appointee to jump through expensive and time-consuming hoops. In circumstances where there is no longer the concept of official liquidator and therefore no obligation on registered liquidators to take appointments, and in light of the increased cost through ASIC user pays, the IRL Committee questions whether there would liquidators prepared to take such appointments.

Rating: 3

13. Government Liquidator

59. There was some divergence of opinion on the government liquidator concept. There were concerns about how it would work in practice – private liquidators have the expertise in conducting liquidations. The cost of setting up and maintaining a huge government arm to deal with these types of liquidations may be significant. On the other hand, it may be problematic if the government liquidator is not resourced

sufficiently to at least carry out basic investigation to identify whether claims are available and a private appointment is warranted. These initial investigations may be more difficult than in a personal insolvency context, where a lot of assets are held, or where they are held by individuals in real property.

60. If this suggestion goes ahead, the government would need to staff it with sufficient properly paid and well-motivated staff. Otherwise, a fairly basic concealment strategy will be enough to deceive the staff and we are no further advanced.

Rating: 3

14. Removing the 21-day waiting period for a DPN

61. This proposal was generally not supported. If this proposal is adopted, it must be confined to HRPOs and the status of HRPO must be soundly based upon prior wrongdoing, not merely incompetence.

62. There is the risk of regulatory drift in this space. In our members' experience, directors typically require the 21-day period to investigate whether the company has resources available to pay the tax, take advice on their options moving forward and whether a rescue plan is achievable and as a board make a decision on whether an appointment needs to be made over the entity. The fact that this time period may exploited by some directors should not be used as a reason to deprive the vast majority of directors from having the time they need to get the proper advice they need and reach a considered decision about the future of the company. Without proper safeguards, the removal of the 21 day waiting period is likely to lead to more companies being placed into formal insolvency without due consideration of their options and may ultimately lead to poorer business recovery outcomes.

63. It would also be grossly unfair to broaden the DPN to where notifications are not yet due but will become due in the next reporting cycle. A better way of addressing this concern (which arises particularly in respect of property developers) would be to require a security bond and to enable the withholding of refunds where a security bond is not provided.

64. We also think Treasury needs to consult further on the actual workings of the DPN regime. The DPN regime imposes a director penalty the instant the company fails to remit the PAYG concerned, not after the expiry of 21 days from service of a DPN. Liability is immediate, but if the DPN is served and the director does one of the three things, liability is thereby remitted. It should also be noted that a DPN is merely a precursor to the commencement of court proceedings. It is not required to be issued before other action to recover the director penalty (such as withholding a tax refund or garnisheeing the director's bank account) is taken.

65. Further, the expiry of a DPN does not entitle the ATO to do anything except commence proceedings. Directors (and any other defendant in any other type of civil litigation) are always free to dispose of personal assets if someone sues them, absent an interim freezing order being obtained. The ATO should be in no more advantageous position and has the ability to apply for freezing orders.

66. If there is evidence to support the concern that directors are using that 21 days to dispose of person assets, perhaps the solution is to make it an offence for directors to dispose of assets during that period. However, it is likely that such a transaction would be voidable in a bankruptcy in any event. The proposal effectively removes a

director's ability to legitimately relieve themselves of this personal liability if the ATO has decided to designate them as an HRPO.

67. It is not clear whether an appeal of this designation would reinstate the 21 days. This could cause significant difficulties if the ATO has been overzealous in its use of its designation power.

Rating: 1

Conclusion

68. The IRL Committee would welcome the opportunity to participate in further consultation on development of these policies.

Taxation Law Committee of the Business Law Section comments

69. The Taxation Law Committee (**the Tax Committee**) of the Business Law Section of the Law Council of Australia welcomes the opportunity to provide comments on Treasury's Consultation Paper on 'Combatting Illegal Phoenixing'.

70. The Tax Committee notes that the Consultation Paper raises matters that are concerned with, inter alia, insolvency, corporations law and taxation law. In general, we have confined our comments to the taxation aspects of the Consultation Paper. However, we note that some of the proposals relating to taxation are dependent on the ability to draft a satisfactory "phoenix offence" provision and our comments relating to those proposals will be dependent on decisions made about such a provision.

71. The Tax Committee also notes the long running research and commentary surrounding the phoenix conundrum, including a major Australian Research Council funded research undertaken by Melbourne Law School and Monash Business School researchers. The project's most recent report entitled "Phoenix Activity: Recommendations on Detection, Disruption and Enforcement" is dated February 2017 (**the Melbourne Law School Phoenix Report**):

    http://law.unimelb.edu.au/__data/assets/pdf_file/0020/2274131/Phoenix-Activity-Recommendations-on-Detection-Disruption-and-Enforcement.pdf.

72. The Tax Committee notes that Treasury undertook consultation in 2009 ("Action Against Fraudulent Phoenix Activity", Proposals Paper, November 2009) that contained proposals relating to taxation that have not been included in the Consultation Paper. The Committee also notes the Law Council's 2010 submission to Treasury in response to that paper.

73. The Tax Committee provides comments below on the issues raised in the Consultation Paper that we believe are tax-related: proposals 5 to 8, 10 and 11.

5. Promoter penalties

74. The effectiveness of the current promoter penalty regime is itself difficult to determine and it is consequently difficult to anticipate whether an extension of this regime to illegal phoenixing is likely to be effective. The promoter penalty regime, found in Division 290 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) (**TAA**), comprises two penalties:

    (a) a penalty applicable to **promoters** of tax exploitation schemes, which involves complex questions of who is a promoter as distinct from adviser, and what constitutes a tax exploitation scheme; and,

    (b) a penalty applicable to persons who **implement** a scheme not in conformity with the manner described in a relevant product ruling.

75. Although these provisions were introduced in 2006, only a handful of applications have been made by the Commissioner to the Federal Court, though all have been successful.[4]

[4] The first promoter penalty case was decided in 2013: see *Commissioner of Taxation v Ludekens* [2013] FCAFC 100 and, determining the amount of penalty to be imposed, *Commissioner of Taxation v Ludekens*

76. The regime also provides for voluntary undertakings. These are private arrangements with the Commissioner and are therefore not publicly available, so it is difficult to comment further on the number or nature of any undertakings. It may be that the real impact of the promoter penalty regime is around creating behavioural change, and again, difficult to measure.

77. The Consultation Paper suggests an alternative approach to create a new limb (effectively amounting to a third penalty within Division 290 of the TAA) based on the promotion or facilitation of 'illegal phoenix activity' as defined elsewhere in the Paper as '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.'[5]

78. Technically, it is difficult to construct a meaningful definition of the offending behaviour that does not over-reach and potentially penalise the provision of proper insolvency advice.[6] Any expansion of the s 290-65 definition of 'tax exploitation scheme' to encompass illegal phoenixing is very difficult. This is in part because the current definition is centred on the concept of 'scheme benefit', for the reduction of a tax-related liability (s 284-150 of the TAA), rather than the avoidance of payment of such debts per se.

79. Further, a significant issue with expanding the reach of the tax promoter penalty as proposed pushes the reach of the penalty beyond tax-related debts. As such, it is arguably beyond the administrative powers of the Commissioner of Tax to pursue such penalties. If such a measure is considered further, it is submitted that it is more appropriate to link the promoter or facilitator penalty to the phoenixing offence proposed for the *Corporations Act 2001* (Cth) and enforced by ASIC.

6. Extending the director penalty notice regime to GST

80. There is a divergence in views within the Tax Committee regarding this proposal. As Treasury recognised in its 2009 proposal paper,[7] extending the DPN regime beyond its current application to liabilities such as GST will take the regime beyond its original policy intent and therefore requires strong public interest grounds. It is important to recognise that the DPN regime has the effect of extending to directors' personal liability for the company's relevant obligations and therefore is not a step to be taken without due consideration of policy justifications and practical implications. The current application of the DPN regime to PAYG withholding and super guarantee reveals a policy of enforcing compliance with obligations linked to employee entitlements but, as the Inspector General of Tax noted in its Debt Collection report, "it is uncertain whether the broader public would consider GST to be of the same importance as employee entitlements".[8] The relevance of the link to employee entitlements is also reflected in the recent work of the Super Guarantee Cross Agency

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[2016] FCA 755, more recently *Commissioner of Taxation v Arnold (No 2)* [2015] FCA 34. The first and only case to date applying the implementer penalty, see *Commissioner of Taxation v Barossa Vines Ltd* [2014] FCA 20.

[5] The Treasury, *Combatting Illegal Phoenixing, Discussion Paper* (2017) at p 18.

[6] M Lane, *The many connotations of 'Phoenixing'* Worrells (2014); A Matthew, *The conundrum of phoenix activity: Is further reform necessary?* QUT Research Paper 95/01 (1995); R Tomasic *Phoenix companies and corporate regulatory challenges* (1996) 6 Australian Journal of Corporate Law 461; D Morrison, *The addition of uncommercial transactions to s588G and its implications for phoenix activities* (2002) 10 Insolvency Law Journal 229; H Anderson et al, *Phoenix Activity: Recommendations on Detection, Disruption and Enforcement* (2017) (hereinafter the *Melbourne Law School Final Phoenix Report*) at 126.

[7] The Treasury, *Actions Against Fraudulent Phoenix Activity, Proposals Paper* (2009) at p 14.

[8] Inspector-General of Taxation, *Debt Collection* (2015) (hereinafter *IGT Debt Collection Report*) [4.52].

Working Group[9] and the Government's recent announcement to strengthen the DPN regime with regard to workers' superannuation.[10] One argument is that GST obligations are of a different nature from income tax liability, since for GST the taxpayer is effectively acting as the collection agency on behalf of the ATO. The same however can be said for other obligations, such as withholding tax. A concern is that, once the policy justification for the DPN regime as a protection for workers has been abandoned, there will be no necessary limit to the extension of the regime to any or all tax regimes. While the Melbourne Law School Phoenix Report notes that extending the DPN regime may not elevate the Government's standing as against employees and other creditors in relation to claims against the company assets,[11] it does create a direct claim for the debt as against the directors by way of the penalty that employees would have neither have access to nor derive any benefit from. The creation of an avenue for recovery from directors connected to the company debt will, in effect, be an advantage for the Government.

81. The Melbourne Law School Phoenix Report supported the extension of the DPN regime however also raised an important point of caution regarding the potential impact of extending it.[12] The data compiled in the IGT Debt Recovery Report suggest that DPNs are associated with becoming insolvent, with 21 per cent of businesses (both large and small) becoming insolvent after the issue of a DPN.[13] The difficulty for Treasury will be the measurement and implementation of balancing insolvency concerns caused by the issue of DPNs against the Government's concurrent agenda to encourage innovation by, among other measures, creating a safe harbour from the insolvent trading provisions for company directors.[14]

82. From the point of view of collecting tax the DPN may be seen to be an effective instrument and it is a matter for the government to determine whether an extension of the DPN regime to GST is appropriate. The Melbourne Law School Phoenix Report refers to minutes of the Interagency Phoenix Forum from 2013 that revealed a GST focus on the building and construction industry.[15] The problem highlighted was that input tax credits may legally be claimed in the earlier stages of a project whilst GST need only the charged and paid when sales later commence. This issue is inherent in the application of the GST mechanism to this industry and it is suggested that any extended DPN regime cannot, of itself, rectify this structural timing mismatch in these circumstances since it has the potential to be triggered only after the project reaches the final stages involving sales. Other more targeted mechanisms, such as the Government's current proposal to impose a GST withholding obligation on purchasers of newly constructed residential properties, may be more likely to be effective in addressing this issue.

7. Security Deposits

83. The Tax Committee suggests that it is inappropriate to extend the garnishee power to security deposits. As a threshold matter, given that the Commissioner's usual debt

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[9] Super Guarantee Cross Agency Working Group, *Superannuation Guarantee Non-Compliance* (31 March 2017).
[10] The Hon Kelly O'Dwyer, Minister for Revenue and Financial Services, *Turnbull Government backs workers on superannuation* (29 August 2017).
[11] *Melbourne Law School Final Phoenix Report* at p 75.
[12] *Melbourne Law School Final Phoenix Report* at 76.
[13] *IGT Debt Collection Report* at [4.44].
[14] Treasury Laws Amendments (2017 Enterprise Incentives No 2) Bill 2017. D Morrison *Company directors in the spotlight: A safe harbour or plugging another imaginary link?* (2017) 25 ILJ 147; D Morrison, S Gray *Phoenixing at the fulcrum: Less faff, faster forward formulation* (2016) 24 ILJ 267.
[15] *Phoenix Project Final Report* at 74.

collection powers cannot be used to collect the amount of a security deposit from the taxpayer, it is difficult to understand the public policy argument supporting a power to collect such an amount from a third party.

84. The garnishee power is only available to the Commissioner in the limited circumstances listed in s 260-5(1) of Schedule 1 to the TAA. This requires that a tax-related liability or an amount determined by a court (the debt) is payable to the Commonwealth by an entity. The term tax related liability is defined in s 255-1 of the TAA as a "pecuniary liability to the Commonwealth arising directly under a *taxation law (including a liability the amount of which is not yet due and payable)". As discussed by Hill J in the GIO case in relation to the original garnishee power in s 218 of the ITAA 1936, it is necessary that there be an unpaid tax debt upon which the notice is based.[16] The interest created by a garnishee notice has been considered to be in the nature of a statutory charge in favour of the Commissioner over the debts due to the taxpayer.[17] Although the nature of this interest may have changed with the introduction of the *Personal Property Securities Act 2009* (Cth), it is clear that this mechanism is only available for legally enforceable tax debts. Therefore, to extend this power to security deposits is an unacceptable extension of the Commissioner's powers and might be viewed as an attempt to reinstate the Commonwealth priority over taxation debts.

85. Also while the availability of judicial review (but not merits review) of a decision to use the garnishee power can be considered appropriate under the current rules since the taxpayer generally has the right to merits review with regard to the underlying debt. As there is no right to object against the Commissioner's decision to require a security deposit, it is inappropriate to deny the objection right with regard to the decision to seek to recover such an amount under the proposed mechanism.

8. Targeting higher risk entities

86. Given the nature of the proposed criteria for being designated as an HRE as well as the potential breadth of measures applicable to HRPOs, that extend beyond issues of tax liabilities, it seems more appropriate for ASIC to be responsible for making any such designation. ASIC ought to be enabled to obtain information regarding tax compliance history from the ATO in making these determinations.

87. Given the significant impact that follows from designation as an HRPO, it is necessary that a potential target be given adequate notice and opportunity to be heard. Given the need to act swiftly, the notice of designation could continue to have effect whilst any review process is underway.

10. Removing the 21-day waiting period for a DPN

88. It may be appropriate to remove the 21-day waiting period for directors already designated as HRPOs but such a change must not apply to directors more generally. The waiting period found at s 269-35 of the TAA provides a director with 21 days after the DPN is given to undertake one of the three actions noted in the Consultation Paper. If none have occurred within the 21 days, the Commissioner can then commence recovery action against the director for the penalty. The notice period is critical to provide directors with the opportunity to investigate the circumstances identified in the DPN, seek advice and take appropriate action. The concern identified in the Consultation Paper that HRPOs will instead use this period to dissipate their

[16] *DCT v Government Insurance Office of NSW* (1993) 117 ALR 61 at 75.
[17] Decision of the Full Federal Court in *Macquarie Health Corp v C of T* [1999] FCA 1819.

own assets, and thereby frustrate recovery of the penalty, may be sufficient to justify the removal of the waiting period but only for such HRPOs.

11. Providing the ATO with the power to retain refunds

89. It may be appropriate to broaden the power to retain refunds in the case of an HRPO where lodgements are outstanding that may affect the tax liability. It is possible to amend s 8AAAZLG of the TAA to nominate those categories of additional lodgements. However, the more pressing concern identified in the Discussion Paper[18] arises instead from non-aligned lodgement cycles and this forms at least part of the rationale for question 94 regarding the possible expansion of the power further to notifications not yet due. It is difficult to sustain a rule that simply allows for the retention of refunds otherwise due to an HRPO without any limit but an alternative could be to consider options to advance lodgements or notifications and thereby shorten these perceived gaps. This might include developing a modified PAYG instalment system for HRPOs (and falling within the BAS provisions currently covered by s 8AAZLG of the TAA), or, making greater use of the Commissioner's existing special returns power in s 163 of the *Income Tax Assessment Act 1936* (Cth).

Other observations

90. There are other key considerations worthy of comment in relation to the wider problem of phoenix company behaviour.

Comment on use of existing powers

91. The Commonwealth has significant powers residing with both the corporate regulator (ASIC) and the revenue authority (ATO). It is not clear that these powers are being executed in a timely manner[19] and there is a perception that perhaps the regulators are not properly resourced.[20] It is important that due consideration be given to how phoenixing is being dealt with by all relevant regulators and how timely current actions are before introducing further laws that will add to both the existing delay and the complexity of their implementation.

92. This analysis is important to identifying the next legislative actions. If the legislation is considered to be flawed or incomplete, then action may be appropriate to be rectify the gaps. If the legislation is not being administered proactively, then perhaps additional focus or resources might be needed. If the issue is the identification of agencies to administer phoenix company activity involving fraud against many parties not just the Commonwealth, these issues could be identified in order to address them.

93. The Tax Committee suggests that the law already contains offence measures sufficient to extend criminal prosecution to such promotion or facilitation behaviour, not apparently discussed in the Treasury paper. Specifically the current offence of conspiracy to defraud the Commonwealth, that gives rise to a maximum penalty of 10 years imprisonment,[21] may apply and may also trigger proceeds of crime forfeiture

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[18] *Discussion Paper* (2017) at p 32.
[19] Note the decision in *Commissioner of Taxation v Warner* [2015] FCA 659 and commentary upon the decision in D Morrison *Floundering around the phoenix: Is it possible to use court proceedings effectively?*
[20] H Anderson, J Hedges, I Ramsay, M Welsh *At the coalface of corporate insolvency and phoenix activity: A survey of ARITA and AICM members* (2016) 24 ILJ 209.
[21] *Criminal Code Act 1995* (Cth), Sch 1, Criminal Code (Criminal Code) s 135.4.

action and link to a money laundering offence.[22] In addition the *Crimes (Taxation Offences) Act 1980* (Cth) may have application.

94. The lack of discussion is problematical. If the law is flawed or incomplete, then a useful starting point might to be rectify the gaps. If the law is not being administered proactively, then perhaps additional focus and/or resources might be needed. If the issue is the challenge of co-ordination given that phoenix company activity might involve fraud against many parties not just the Commonwealth, then the identification of the gaps is the first step in addressing the problem.

Sharing of information among agencies

95. It is imperative that the information held by regulatory agencies is shared as amongst themselves and for members of the public to access freely where appropriate. The apparent inability for any interested party to make a simple computer check of the ASIC website to determine how many companies an individual has been a director of, and, whether or not those companies are insolvent is remarkable. It is submitted that making relevant information readily accessible will increase transparency and reduce the likelihood of perverse outcomes referred to above. We understand that Treasury and other initiatives such as the Black Economy Taskforce are looking at these areas but again it is important to transparently identify the issues in an open and consultative manner.

Scope of Director Identification Number proposals

96. The media release of Minister for Revenue and Financial Services, Kelly O'Dwyer, of 12 September included the following:

> *The Government's comprehensive package of reforms will include the introduction of a Director Identification Number (DIN) and a range of other measures to both deter and penalise phoenix activity.*
>
> *The DIN will identify directors with a unique number, but it will be much more than just a number. The DIN will interface with other government agencies and databases to allow regulators to map the relationships between individuals and entities and individuals and other people."*

97. The Tax Committee has not seen any further detail of this DIN proposal.

98. We observe that the term 'director' as defined in section 9 of the Corporations Act does not encompass persons acting as officers, if they do not also act within the scope of the definition of 'director'.

99. The restricted definition of director was considered for example in the 2012 case of *Grimaldi v Chameleon Mining NL (No 2)*,[23] concerning a person not being an authorised director, but who had either abrogated to himself, with the acquiescence of the other directors, or was given by them, functions expected to be performed by a director of the company. The Federal Court held, that on the facts of that case, while the individual was not a director "(g)iven the extent and the significance of those

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[22] For a discussion of some of these alternatives see C Black, 'Combatting serious tax non-compliance: Tax fraud and money laundering' (2016) 45 *Australian Tax Review* 225.
[23] [2012] FCAFC 6.

functions, he so acted in the position of a director as to warrant the imposition on him of the liabilities, statutory and fiduciary, of a director."[24]

100. The Tax Committee highlights that the wide but targeted definition of director, and the potential need for a broader coverage of the DIN to corporate officers, are issues worthy of examination in the development of the DIN mechanisms.

Conclusion

101. The Tax Committee is ready to participate in further consultation on development of these policies.

102. We welcome involvement in the development of the DIN and related disclosures.

[24] Ibid, at 133.