

23rd March 2010

PHOENIX ACTIVITY - ATO proposed changes will expose Directors

Similar to the mythical creature (the Phoenix is re-born by recreating itself through fire and 'rising from the ashes'), a general interpretation of 'phoenix activity' involves a director who has transferred assets from a company that is facing or nearing insolvency to a new risen 'phoenix' company under a similar directorship. The intention is to continue the original business leaving the original company with a trail of unpaid debts and no assets to pay its liabilities. This is also commonly referred to as "asset stripping" which often involves a sale of all or parts of company assets that is at undervalue or for no consideration. Phoenix activity as it is known to the ATO is "*the evasion of tax through the deliberate, systematic and sometimes cyclic liquidation of related corporate trading entities*".

Fraudulent phoenix activity has recently taken the spotlight in the Courts and these practices are certainly on the radar of Government watchdogs ASIC and the ATO. Notably in the recent decision of ASIC v Somerville & Ors [2009] NSWSC 934, ASIC succeeded in obtaining declarations of breach of directors' duties under the Corporations Act 2001 (Cth) against the directors of eight unrelated companies and their solicitor (Somerville), who advised and assisted each of those directors in relation to phoenix activity.

Despite mechanisms contained in existing taxation legislation and the Corporations Act 2001 to address and deter phoenix activity in Australia, phoenix activities are on the rise and it has become evident that more businesses are today faced with financial pressures and liquidity constraints arising from the global downturn.

The ATO estimates that the suspected phoenix cases it is currently monitoring poses a risk to its revenue of approximately \$600 million in unremitted taxes. Recent findings have estimated the cost to the Australian economy of phoenix and related practices is between \$1 billion to \$2.4 billion a year.

The Commonwealth Treasury released a **discussion paper in November 2009** on the Government's proposals to take action against fraudulent phoenix activity. The main proposal changes can be summarised as follows:

1. *Expanding the director penalty regime to apply to liabilities such as superannuation, excise, GST, and also company income tax to allow an automatic penalty provision and **personal attachment of the liability to the directors automatically if taxes remain unpaid after 3 months from its statutory due date.***
2. *Amending the promoter penalty regime to target those individuals promoting fraudulent phoenix activity i.e. accountants, lawyers and or advisors*
3. *Reintroducing a provision that would make it an offence for an entity not to remit the required PAYG amounts*

4. <i>Making directors personally liable for the debts of a liquidated company in circumstances where a 'new' company adopts the same or similar name as its previous incarnation.</i>
5. <i>Adopting the doctrine of inadequate capitalisation which will allow the corporate veil to be lifted where a company sets up a subsidiary with insufficient capital to meet the debts that could reasonably be expected to arise.</i>
6. <i>Amending the taxation bond provision to provide a Commissioner of Taxation with the discretion to require a company to provide an appropriate bond if there is reason to suspect the company is unable to meet its tax liabilities and or engage in fraudulent phoenix activity.</i>

On Wednesday 17th March, the Assistant Treasurer **announced the Government will take immediate action** to assist in the crackdown on "phoenix" activity by **expanding and reforming the use of "security deposits"** (similar to a bond).

This will significantly **increase penalties for failing to comply** with the requirement to provide a security deposit **at the direction of the Deputy Commissioner of Taxation** in relation to an **existing or future tax liability**.

These **changes have been introduced into Parliament that will apply to the 2010-2011 and later income years**.

In addition to boosting the ATO's ability to crackdown on phoenix activity, the updated provisions also apply to situations such as:

- *where a taxpayer plans to temporarily carry on an enterprise in Australia and leave without returning;*
- *where the taxpayer has a history of non-compliance (including by defaulting on their tax liabilities);*
- *where the directors of a corporate taxpayer have a history of non-compliance; and*
- *where the Commissioner is granting a taxpayer the benefit of a payment arrangement.*

Some of these proposed changes are likely to increase insolvency appointments and may also lead to the following:

1. <i>An increase in directors making contact with their accountants on a regular basis and seek solutions to strategically drive their business together with keeping abreast with tax compliance.</i>
2. <i>Advisors educating their clients to get early intervention to address the underlying causes seen in companies liquidated.</i>
3. <i>An increase in voluntary administrations and creditors' voluntary liquidations as directors choose to protect their personal asset position rather than consider the possibility of turning around their business.</i>
4. <i>A change in focus by directors to be more involved with the day to day operations of their business and will perhaps encourage more turnaround activity with a turnaround management specialist to look at business survival as oppose to going down the insolvency path. This may in time reduce the number of insolvencies in the long term. Advisors will also need to be conscious that if strategies implemented for a turnaround fails then the directors may be left incurring further unpaid debts (particularly with personally guaranteed creditors) and the new automatic personal liabilities for company taxes.</i>

Any changes to be passed by Parliament will need to strike a balance of the severity of the additional deterrents with the need to ensure that innocent directors and companies are not captured through honest mistakes. The Government will also need to ensure honest businesses are not exploited or even destroyed by being placed into insolvency administration through fear of personal asset seizure. If this is not done, this will discourage experienced individuals to act as directors particularly at a time where entrepreneurship needs to be encouraged.

If you wish to discuss these proposed tax reforms, or any other Insolvency matters, we would be more than happy to assist.

Yours Faithfully
SV PARTNERS

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