A Framework for Corporate Insolvency Taxation: The Crossroads of the Theoretical Perspectives in Taxation Law and Insolvency Law

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Abstract

The first aim of this thesis is to develop a theoretical framework that can be used to analyse the effectiveness of Australian laws and administrative practices that sit at the crossroads of tax law and insolvency law, and to propose options for law reform and administrative reform where significant disharmony between these areas of law is identified. The second aim of this thesis is to apply the theoretical framework to assess the effectiveness of the Australian Federal Commissioner of Taxation (Commissioner) as a creditor in a corporate insolvency, and to propose law reform.

In particular, this thesis applies the theoretical framework to answer the following questions:

1. Should the Commissioner have priority in a corporate insolvency?

2. Is there harmony at the intersection of tax law and insolvency law with respect to the Commissioner's debt collection practices in the context of tax administration?

3. Is there harmony at the intersection of tax law and insolvency law with respect to the Commissioner's powers to issue:

    a. notices under section 260-5 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) (TAA 1953)?

    b. director penalty notices under Division 269 to Schedule 1 of the TAA 1953 (DPNs)?

c. statutory demand notices under section 459E of the *Corporations Act 2001* (Cth) (Corporations Act)?

The significance of this thesis is to develop an appropriate theoretical framework as a new tool to assess the effectiveness of a law, the interrelationship of laws and administrative practices with respect to both tax law and insolvency law, and to propose law reform. The theoretical framework is applied in relation to one area that sits at the intersection of tax and insolvency law, being the role of the Commissioner as a creditor in a corporate insolvency with respect to the Commissioner's debt collection powers under the tax law and the Commissioner's debt collection practices in the context of tax administration. Whilst the theoretical framework is applied in relation to this one particular area, it is intended that the framework has far broader application and can be used in relation to analysing the effectiveness of any law that sits at the intersection of tax law and insolvency law.

Publications Arising From the Writing of this Thesis To Date

‘Tax Collection, Recovery and Enforcement Issues for Insolvent Entities’ (2016) 31(3) *Australian Tax Forum* 425.

'Director Penalty Notices - Promoting a Culture of Good Corporate Governance and of Successful Corporate Rescue Post Insolvency' (2016) 25(1) *Revenue Law Journal* Article 2.

'The Insolvency Priority Contest - Garnishee Notices versus General Law Fixed Interests and PPSA Security Interests' (2015) 2(6) *Australian Tax Law Bulletin* 112.

'The Legislative Interface Between the Creation of a Liability to Tax and the Right to Challenge That Liability' (2014) 29 *Australian Tax Forum* 551.

'The Commissioner's Power to Issue Creditor's Statutory Demands: Implications for Corporate Rescue Post Insolvency' (2014) 43 *Australian Tax Review* 187.

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Originality Statement

I certify that this work contains no material which has been accepted for the award of any other degree or diploma in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where due reference has been made in the text.

In addition, I certify that no part of this work will, in the future, be used in a submission for any other degree or diploma in any university or other tertiary institution without the prior approval of the University of Adelaide and where applicable, any partner institution responsible for the joint-award of this degree.

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Glossary

The following abbreviations and acronyms are used throughout this thesis:

Abbreviation/ Acronym	**Definition**
AAT	Administrative Appeals Tribunal
ADJR Act	*Administrative Decisions (Judicial Review) Act 1977* (Cth)
ANTS	A New Taxation System
ARITA	Australian Restructuring Insolvency and Turnaround Association
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
BAS	Business Activity Statement
BISEP	Business, industry, sociological, economic, and psychological
BVAT	Business Viability Assessment Tool
C2P	Capacity to Pay
CGT	Capital Gains Tax
Commissioner or FCT	Australian Federal Commissioner of Taxation
Cork Report	United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice,* Cmnd 8558 (1982)
Commonwealth or Cth	Commonwealth of Australia

Corporations Act	*Corporations Act 2001* (Cth)
DCT	Australian Deputy Commissioner of Taxation
DMF	Debt Management Framework
DOCA	Deed of Company Arrangement
DPN	Director Penalty Notice
DRN	Debt Right Now
EDCA	External Debt Collection Agency
ERMF	Enterprise Risk Management Framework
ETAAC	US Electronic Tax Administration Advisory Committee
Federal Court	Federal Court of Australia
GFC	Global Financial Crisis
GIC	General Interest Charge
GST	Goods and Services Tax
Harmer Report	Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988)
HCA	High Court of Australia
HMRC	Her Majesty Revenue & Customs
ICA	Institute of Chartered Accountants
IGT	Inspector General of Taxation

IMF	International Monetary Fund
IRS	Internal Revenue Service
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
OECD	Organisation for Economic Co-operation and Development
OIC	Offer in Compromise
P2P	Propensity to Pay
PAYE	Pay As You Earn
PAYG	Pay As You Go
PPSA	*Personal Property Securities Act 2009* (Cth)
Proposals Paper	Australian Treasury, *'Action Against Fraudulent Phoenix Activity'* (2009)
PS CM	Corporate Management Practice Statement
PS LA	Law Administration Practice Statement
RBA	Running Balance Account
RBC	Royal Bank of Canada
SBR	Standard Business Reporting
SGC	Superannuation Guarantee Charge
SME	Small-to-Medium Enterprise

SMS	Short Message Service
STA	Swedish Tax Agency
SGAA 1992	*Superannuation Guarantee (Administration) Act 1992* (Cth)
TAA 1953	*Taxation Administration Act 1953* (Cth)
UK	United Kingdom
UNCITRAL	United Nations Commission on International Trade Law
US	United States of America

Chapter 1 - The Intersection of Tax Law and Insolvency Law: The Need for a Framework

> What is it that causes many toilers in the fertile fields and vineyards of bankruptcy law to steer clear of recurring tax issues? Why can one go to countless bankruptcy seminars and never hear the word "tax" mentioned? Unfortunately, like the snake, tax issues in bankruptcy strike at the heel of the toiler, who unsuspectingly thinks she has transversed its path without incident.
>
> ….Nevertheless, there is a dire need to rethink and reunify bankruptcy and tax policy. For fear of being lured into the abyss of two technical and unforgiving bodies of law, we must remain cognizant of what exactly the law attempts to accomplish in a particular instance. Asking the wrong question makes it doubly difficult to reach even an almost right answer.[1]

Introduction

This thesis commences by providing a thesis overview and objective. The chosen research methodology is then explained, and the structure of this thesis is outlined. The chapter then provides a literature review on the scholarship to date in Australia and internationally in the area of the intersection of taxation and corporate insolvency law and theory. The chapter then discusses how a theoretical framework for corporate insolvency taxation (Framework) will be developed and applied in this thesis. Finally, the chapter concludes by stating the significance of this thesis and outlining research limitations for this thesis.

[1] Prominent US bankruptcy taxation scholar, Jack F Williams, 'Rethinking Bankruptcy and Tax Policy' (1995) 3 *American Bankruptcy Institute Law Review* 153. In the United States of America (US) and the United Kingdom (UK), 'bankruptcy' means personal insolvency as well as corporate insolvency.

Thesis Overview

Raising revenue through taxation to fund Government activities and public purposes, such as welfare, health, education and defence, is a fundamental feature of any modern society.[2] In fact, it is commonly accepted that 'taxes are what we pay for a civilised society'.[3]

The global financial crisis (GFC) had a considerable impact on the Australian economy resulting in decreases in net revenue in 2008–09 and 2009–10, and coupled with this, a further increase in the level of collectable debt.[4] Post the GFC, the Australian economy is still experiencing economic uncertainty due to the volatility of global financial markets.[5] There has been a continual growth of collectable debt over the last decade with the Australian Taxation Office's (ATO's) most recent annual report stating that the level of ATO collectable debt is approaching 20 billion dollars.[6] In this environment the ATO is carefully managing its approach to debt collection to contain debt levels at acceptable limits.[7] There are two inquiries that have recently been undertaken in Australia that were

[2] *R v Barger* (1908) 6 CLR 41; Justice Gaetano Pagone, 'Aspects of tax avoidance - Trans-Tasman Observations' (2011) 40 *Australia Tax Review* 145, 163; Murray Gleeson, 'The meaning of legislation: context, purpose and respect for fundamental rights' (2009) 20 *Public Law Review* 26, 32.
[3] *Compania de Tobacos v Collector* 275 US 87 (1904).
[4] FCT, *Annual Report 2008–09* (2009) 47, 53; FCT, *Annual Report 2009–10* (2010) 37, 50.
[5] FCT, *Annual Report 2013-14* (2014) 14; Emma Armson, 'False trading and market rigging in Australia' (2009) 27 *Company and Securities Law Journal* 411.
[6] FCT, *Annual Report 2014-15* (2015) 44.
[7] Australian National Audit Office, *'Audit Work Program'*, July 2012, Section 2, ATO.

prompted by these concerns and the impact of these concerns upon the provision of government services.[8]

In the international context, it has been estimated that in respect of the Organisation for Economic Co-operation and Development (OECD) governments alone, around two thirds of a trillion US dollars were owed in undisputed tax debts at the end of 2013.[9] Accordingly, in both the Australian and international context, the management of tax debt is a major concern for revenue authorities.

One recent study found that on average, the time taken to pay debts in Australia has slowed to its lowest rate in three years which is approaching that observed during the peak of the GFC in 2008–09.[10] It has been suggested that the slowing in payment times is evidence that businesses are experiencing financial pressure and are finding it difficult to manage their cash flows and finances.[11] Primary (forestry and mining) and secondary industries (utilities, construction, retail and finance) appear to be the most affected.[12]

In another recent study, it was observed that corporate insolvencies have continued to grow with approximately 10,000 businesses entering some form of insolvency administration each year.[13] Furthermore, over 80 per cent of these

[8] Australian Government, IGT, *'Debt Collection, A report to the Assistant Treasurer'* (2015); Parliament of the Commonwealth of Australia, House of Representatives Standing Committee on Tax and Revenue, *Tax disputes* (2015).
[9] OECD, *Working Smarter in Tax Debt Management* (2014) 15.
[10] Dun and Bradstreet, *'Businesses Facing Cashflow Squeeze'* (2014); IGT, *Debt Collection,* Report to the Assistant Treasurer (2015) 4.
[11] Ibid.
[12] Ibid.
[13] Jones Partners, *Insolvency Report 2014: Insolvency Activity and the State of the National Economy — The Past, Present and Future* (2014) ii.

entities are family–owned small to medium enterprises (SMEs) employing less than 20 workers.[14] Small businesses with turnover between $500,000 and $1 million almost tripled their amounts of insolvency debt from $422 million in 2012–13 to $1.228 billion in 2013–14.[15] Changes in the rate of insolvency are attributable to a number of underlying economic factors, including the economic environment, industry structure, access to credit and overall levels of leverage and the availability of voluntary avenues to deal with insolvency.[16]

In this environment, the role of government in providing financial assistance to financially troubled businesses, to smooth consumption and absorb economic shocks has become increasingly important, however at the same time the adequacy of tax revenue is also being questioned.[17] Given this tension, the appropriate scope of government intervention, including the role that the Commissioner should play in corporate insolvencies, requires further attention and reconsideration. This raises questions such as what role should the Commissioner play in times of economic distress? Should the Commissioner be granted tax priority in a corporate insolvency? What level of administrative and enforcement powers should the Commissioner have available to enforce the tax law? To what extent should the Commissioner offer assistance to financially troubled businesses, thereby smoothing consumption and absorbing economic shocks? What form should such

[14] Ibid.
[15] Ibid.
[16] Ibid; IGT, *'Debt Collection, A Report to the Assistant Treasurer'* (2015).
[17] FCT, *Annual Report 2014-15* (2015) 44; Australian Government, IGT, *'Debt Collection, A report to the Assistant Treasurer'* (2015); Parliament of the Commonwealth of Australia, House of Representatives Standing Committee on Tax and Revenue, *Tax disputes* (2015); Business Council of Australia, *The Future of Tax: Australia's Current Tax System* (2014) 2.

intervention, if any, take? These questions must be answered in order to determine the appropriate role of the Commissioner in a corporate insolvency.

Objective

The objective of this thesis is to develop a theoretical framework that will be applied to assess the role of the Commissioner as a creditor in a corporate insolvency with respect to the Commissioner's debt collection powers under the tax law and the Commissioner's debt collection practices in the context of tax administration. This thesis will achieve its objective by examining the Australian theoretical perspectives of tax law and insolvency law which will lay the foundation for a Framework which will be used to assess and evaluate the level of harmony between these areas of law. In particular, this thesis will apply the Framework to a number of select issues in relation to the role of the Commissioner as a creditor in a corporate insolvency and where considerable disharmony is identified at the intersection of both of these areas of law, recommendations for future law and administrative reform will be made.

Research Methodology

This thesis employs theoretical research in its early chapters to gain an understanding of the conceptual bases of the relevant legal rules and principles with respect to taxation law and corporate insolvency law. Doctrinal research then follows to critically evaluate the legal rules and their interrelationship using both induction and deduction. Proposals for reform are made by providing recommendations for change based upon critical examination. Alternative research

methodologies were explored, such as quantitative analysis and qualitative analysis but both were considered inappropriate for achieving the purpose of this thesis.

Quantitative methodologies are generally appropriate where the purpose of the research is to relate or compare variables.[18] This methodology is often used where the purpose of the research is to test whether the proposed hypothesis about a causal relationship is statistically significant and then to make generalisations about the relationship in the context of a broader population.[19] Research designs that embrace quantitative methodology typically use various forms of experiments and surveys as their main strategies of inquiry.[20] Hence, given the objective of this thesis does not involve examining a causal relationship, quantitative analysis would not be an appropriate research method for the purpose of this thesis.

Qualitative analysis would also be unsuitable for this thesis. Qualitative methodologies generally seek answers to questions and do not prove or disprove a hypothesis.[21] The strategies of inquiry used in qualitative research are in-depth interviews and focus groups and their purpose is to collect 'rich' information that does not fit into other strategies of inquiry.[22] As this thesis intends to limit its scope to investigating legal outcomes deriving from two intersecting areas of law, as

[18] Margaret A McKerchar, 'Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation' (2008) 6(1) *ejournal of Tax Research* 5, 10; Wing Hong Chui, 'Quantitative Legal Research' in Mike McConville and Wing Hong Chui (eds), *Research Methods for Law* (Edinburgh University Press, 2007) 48-49.
[19] Margaret A McKerchar, 'Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation' (2008) 6(1) *ejournal of Tax Research* 5, 10.
[20] Ibid.
[21] Ibid 15; Tania Sourdin, 'Introduction' (2011) 22 *Australian Dispute Resolution Journal* 3, 5.
[22] Margaret A McKerchar, 'Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation' (2008) 6(1) *ejournal of Tax Research* 5, 15.

opposed to the subjective views of individuals, a qualitative study would be inappropriate for achieving the purpose of this thesis.

As this thesis' objective is to assess the effectiveness of the current legislative and administrative framework concerning the role of the Commissioner as a creditor in a corporate insolvency with respect to the Commissioner's debt collection powers under the tax law and the Commissioner's debt collection practices in the context of tax administration, and to propose law reforms in this area, a method involving theoretical research and doctrinal research is considered to be most appropriate. It is most appropriate because in order to assess the effectiveness of the law a theoretical framework will be developed and applied to select areas that sit at the interface of tax law and insolvency law. The framework will be based upon the conceptual bases of the relevant legal rules and principles with respect to taxation law and corporate insolvency law. Secondly, a systematic process of identifying, analysing, organising and synthesising statutes, explanatory memoranda, judicial decisions, academic analysis and contemporary views from industry in relation to the current legislative and administrative framework concerning the role of the Commissioner as a creditor in a corporate insolvency will be undertaken. It is expected that the examination of primary and secondary legal materials in this manner will add to the scholarship in this area and lead to the production of a thesis that suggests recommendations on law reform in relation to the role of the Commissioner as a creditor in a corporate insolvency with respect to the Commissioner's debt collection powers under the tax law and the Commissioner's debt collection practices in the context of tax administration.

Thesis Structure

Chapter 1 - The Intersection of Tax Law and Insolvency Law: The Need for a Framework

The content of Chapter 1 is outlined in the introduction of this chapter.

Chapter 2 – Theoretical Perspectives of Australian Tax Law

Chapter 2 reviews the overarching principles that have laid the foundations for each of the major Australian taxation reviews that have occurred since Federation. This review reveals that the principles of fiscal adequacy, equity, efficiency and simplicity are the fundamental criteria upon which any theoretical approach to Australian tax law design must be undertaken. An inquiry into the meaning of each of these seemingly simple principles highlights that trade-offs between the socio-economic goals of equity, efficiency and simplicity often need to be made. Finally, an assessment is made as to whether these tax policy criteria compel a clear answer to whether there should be any tax liability at all in a corporate insolvency or whether there should be any departure from general tax principles in a corporate insolvency.

Chapter 3 – Theoretical Perspectives of Australian Insolvency Law

Chapter 3 begins by introducing the two most widely accepted theoretical perspectives in insolvency law, the creditors' bargain theory and the communitarian perspective. Through examining the possible theoretical and philosophical bases of corporate insolvency law, it is demonstrated that each of these theories has implications for a theory of corporate insolvency tax, which are at times counterintuitive. In particular, the tax treatment of a corporation in

insolvency must have a public law element and so the chapter gives greatest support to the communitarian perspective. The chapter concludes by considering the development of a framework that deals explicitly with corporate insolvency tax.

Chapter 4 – The Role of the Commissioner as a General Unsecured Creditor in a Corporate Insolvency

Chapter 4 considers the role of the Commissioner as a creditor in a corporate insolvency with respect to the priority of tax claims. The chapter begins by providing a historical overview of the priority of tax claims in a corporate insolvency in Australia beginning with the Imperial Statutes of England and concluding with the Law Reform Commission inquiries that led to the abolition of tax priority. The chapter assesses Australia's current position against the Framework that is developed in Chapters 2 and 3. Finally, the chapter concludes by evaluating the role of the Commissioner as a general unsecured creditor in a corporate insolvency.

Chapter 5 – The ATO's Insolvency Debt Collection Framework

Chapter 5 describes the ATO's insolvency debt collection framework, including the number of debt collection strategies that the ATO has developed when dealing with definite and undisputed debt. The chapter discusses the position of a corporate tax debtor that is approaching insolvency or that is insolvent within the ATO's debt collection framework. The chapter assesses the ATO's administrative practices in relation to these tax debtors by applying the Framework, highlighting areas of weakness, and then draws upon the international experience to discuss possibilities for future action.

Chapter 6 – Recourse Against the Insolvent Company: The Commissioner's Power to Issue Garnishee Notices

Chapters 6, 7 and 8 expand on the discussion in Chapter 5 by considering the second element of the ATO's insolvency debt collection framework, 'Firmer Action', in greater depth.

Chapter 6 considers the Commissioner's power to issue to a third party that owes money to, or holds money for a tax debtor, a notice under section 260-5 of Schedule 1 to the TAA 1953. In particular, the chapter explores the operation of the current legislative scheme and the body of case law that has emerged in this area. The Framework is then applied to assess the effectiveness of this tax law in the context of corporate insolvency by determining the level of harmony at the intersection of tax law and insolvency law with respect to the Commissioner's powers to issue notices under section 260-5 of Schedule 1 to the TAA 1953. Finally, areas for law reform and directions for future research and action will be considered.

Chapter 7 – Recourse Against the Insolvent Company's Directors: The Commissioner's Power to Issue Director Penalty Notices

Chapter 7 considers another dimension of the Commissioner's role as a creditor in a corporate insolvency, being the Commissioner's recourse against an insolvent company's directors to recover outstanding tax debts of a company. The chapter considers the director penalty regime under Division 269 to Schedule 1 of the TAA 1953. In particular, the chapter explores the legislative history of the director penalty regime, the operation of the current legislative scheme and the body of

case law that has emerged in this area. The Framework is then applied to assess the effectiveness of this tax law in the context of corporate insolvency by determining the level of harmony at the intersection of tax law and insolvency law with respect to the Commissioner's powers to issue director penalty notices under Division 269 to Schedule 1 of the TAA 1953.

Chapter 8 – Recourse Against an Insolvent Company to Commence Liquidation Proceedings: The Commissioner's Power to Issue Statutory Demand Notices

Chapter 8 explores the Commissioner's right as a creditor to commence liquidation proceedings when dealing with a tax debtor that is approaching insolvency or that is insolvent by issuing a statutory demand notice under section 459E of the Corporations Act. In particular, the chapter explores the operation of the current legislative scheme and the body of case law that has emerged in this area. The Framework is then applied to assess the effectiveness of this tax law in the context of corporate insolvency by determining the level of harmony at the intersection of tax law and insolvency law with respect to the Commissioner's powers to issue notices under section 459E of the Corporations Act. Finally, areas for law and administrative reform and directions for future research and action will be considered.

Chapter 9 - Conclusion

Chapter 9 summarises the results and recommendations that have been made throughout this thesis and calls for their implementation. Finally, the chapter discusses the possibilities for future studies.

Literature Review

Scholarship in the area of the intersection of tax law and insolvency law

In Australia, the interface between tax law and corporate insolvency law has not often featured in tax or corporate law scholarship to date. The study of the interface between these areas of law has been referred to by some commentators as a 'somewhat neglected area in terms of academic study'.[23] However, more recently, there have been some notable contributions to the literature in this area. Leading Australian scholars that have researched the area of corporate insolvency taxation in Australia include Christopher Symes, Colin Anderson, Catherine Brown, David Morrison, John Duns and John Glover.[24] The literature in this area to date has highlighted a number of areas of concern in the area of corporate insolvency taxation in Australia.

Symes has analysed the statutory priorities in Australian corporate insolvency law, including the Commissioner's position as a priority creditor. He questions whether

[23] Catherine Brown, Colin Anderson and David Morrison, 'The Certainty of Tax In Insolvency: Where Does the ATO Fit?' (2011) 19(2) *Insolvency Law Journal* 108.

[24] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status, Markets and the Law* (Ashgate Publishing, 2008); Christopher F Symes, 'Reminiscing the Taxation Priorities in Insolvency' (2005) 1 (2) *Journal of the Australasian Tax Teachers Association* 435; Colin Anderson and Catherine Brown, 'Demanding A Change: Time to Act on Statutory Demands' (2013) 21(2) *Insolvency Law Journal* 97-108; Catherine Brown, Colin Anderson, David Morrison, 'The Certainty of Tax in Insolvency: Where Does the ATO Fit?' (2011) 19(2) *Insolvency Law Journa*l 108-122; David Morrison, 'Why is There a Gap in the Tax Treatment of Solvent Versus Insolvent Companies and Why Does It Matter' (2014) 22 *Insolvency Law Journal* 192-202; John C Duns and John S Glover, 'Insolvency, Tax and Liquidation Distributions: Dividends, Capital Gains and the Dead Hand of the Past' (2006) 15(2) *International Insolvency Review* 109-128; John C Duns and John S Glover, 'The Taxation Priority in Insolvency: An Australian Perspective' (2005) 14(3) *International Insolvency Review* 171-186; John S Glover, 'Insolvency: Calling in the Undertakers: Income Tax, CGT, GST and Stamp Duty Aspects' (2007) 10 *Journal of Australian Taxation* 220-250.

the removal of the Commissioner's priority in a corporate insolvency has achieved its intended objectives.[25]

Anderson and Brown have examined the process of the statutory demand procedure in the context of the current insolvency law in Australia by looking at the policy justification for the process. They argue that a robust analysis of the statutory demand regime is overdue.[26]

Duns and Glover have written two papers that analyse the taxation of liquidation surpluses in Australia.[27] They have also written a paper that draws on the Australian experience to determine whether is it is justifiable to accord special rights to taxation claims in insolvency.[28]

While some of the conflict that lies at the interface between tax law and insolvency law has been identified by this academic literature, there is little analysis around the resolution of the problem of conflicting laws. There has been one notable attempt by Brown, Anderson and Morrison to develop a theory of bankruptcy taxation law.[29] They suggest that 'one means of addressing the inconsistency is to examine whether there is a clearly aligned theoretical basis for the development of

[25] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status, Markets and the Law* (Ashgate Publishing, 2008).
[26] Colin Anderson and Catherine Brown, 'Demanding A Change: Time to Act on Statutory Demands' (2013) 21(2) *Insolvency Law Journal* 97-108.
[27] John C Duns and John S Glover, 'Insolvency, Tax and Liquidation Distributions: Dividends, Capital Gains and the Dead Hand of the Past' (2006) 15(2) *International Insolvency Review* 109-128; John S Glover, 'Insolvency: Calling in the Undertakers: Income Tax, CGT, GST and Stamp Duty Aspects' (2007) 10 *Journal of Australian Taxation* 220-250.
[28] John C Duns and John S Glover, 'The Taxation Priority in Insolvency: An Australian Perspective' (2005) 14(3) *International Insolvency Review* 171-186.
[29] Catherine Brown, Colin Anderson, David Morrison, 'The Certainty of Tax in Insolvency: Where Does the ATO Fit?' (2011) 19 *Insolvency Law Journal* 108-122.

these areas of law and the extent that alignment addresses these inconsistencies'.[30] They call for 'an underlying theoretical approach that provides a more consistent development of law'.[31] They argue that '[a] clearly articulated approach is therefore required to develop and interpret corporate, bankruptcy and taxation legislation so that the development of these areas of law may be more aligned.'[32] The theoretical approach that the authors propose to critically analyse the current regime is a theory such as Dworkin's theory of equality. The authors base their proposal on the common objective for both corporate, bankruptcy and taxation law, being the achievement of equal distribution of scarce resources. They consider that the principle of substantive equality appears a primary objective in the development of law relating to the distribution of assets in insolvency and the imposition of taxation.[33]

In the international context, the most prominent bankruptcy taxation scholarship has come from the US. Leading bankruptcy taxation scholars include Jack Williams, Michelle Arnopol Cecil, William Plumb and Frances Sheehy. Most recently Shu-Yi Oei has contributed to the scholarship in this area. There have been three notable attempts by scholars, Jack Williams, Michelle Arnopol Cecil and Frances Hill, to develop a theory of bankruptcy taxation law.

[30] Ibid 108.
[31] Ibid.
[32] Ibid 122.
[33] Ibid 120.

Professor Jack Williams

Professor Jack Williams is a prominent bankruptcy taxation scholar in the US that has been researching in this area since the early 1990s. In a number of his papers,[34] Williams analyses some of the more obvious conflicts between bankruptcy and tax policy 'in the hope of beginning to build an analytical model providing a coherent and internally consistent logic of bankruptcy taxation'.[35]

As Chair of the Tax Advisory Committee to the National Bankruptcy Review Commission, Williams worked with nine experts in the field of bankruptcy tax to produce a report of over 130 pages, addressing a number of the most difficult issues in tax and insolvency law.[36] This report had a significant impact upon the tax recommendations made by the National Bankruptcy Review Commission and ultimately was considered to be a start at framing a coherent bankruptcy tax

[34] Jack F Williams, 'Rethinking Bankruptcy and Tax Policy' (1995) 3 *American Bankruptcy Institute Law Review* 153-206; Richard C McQueen & Jack F Williams, *'Tax Aspects of Bankruptcy Law and Practice'* (Clark Boardman Callaghan, 3rd ed, 1997); Jack F Williams, 'The Federal Tax Consequences of Individual Debtor Chapter 11 Cases' (1994) 46 *South Carolina Law Review* 1203-1244; Jack F Williams, 'The Tax Consequences of an Abandonment Under the Bankruptcy Code' (1994) 13 *Temple Law Review* 13-66; Jack F Williams and Jacob L Todres, 'Tax Consequences of Post-Petition Income as Property of the Estate in an Individual Debtor Chapter 11 Case and Tax Disclosure in Chapter 11' (2005) 13 *American Bankruptcy Institute Law Review* 701-732; Jack F Williams, 'National Bankruptcy Review Commission Tax Recommendations: Individual Debtors, Priorities, and Discharge' (1997) 14 *Bankruptcy Developments Journal* 1-72; Jack F Williams, 'National Bankruptcy Review Commission Tax Recommendations: Notice, Jurisdiction, and Corporate Debtors' (1997) 14 *Bankruptcy Developments Journal* 261-310; Jack F Williams, 'A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, the Bad, and the Ugly' (1997) 5 *American Bankruptcy Institute Law Review* 445-462; Steven J. Csontos, Carmen R. Eggleston, Hon. Polly S. Higdon, Robin E. Phelan, James I. Shepard and Jack F Williams, 'Bankruptcy Taxation: Congress's Role in Bankruptcy Tax Policy: A Roundtable Discussion' (1995) 3 *American Bankruptcy Institute Law Review* 257-469; Jack F Williams and Tamara Miles Ogier, 'A Collision of Policy: Chapter 13 and Taxes' (1998) 50 *South Carolina Law Review* 313-342.

[35] Jack F Williams, 'Rethinking Bankruptcy and Tax Policy' (1995) 3 *American Bankruptcy Institute Law Review* 154.

[36] United States of America, Tax Advisory Committee to the National Bankruptcy Review Commission, *Final Report* (1997) 5-6; United States of America, National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years,* Final Report (1997).

policy.[37] Williams was also involved in a bankruptcy policy round table discussion which concerned Congress's role in bankruptcy tax policy.[38] A number of comments were made during the roundtable discussion concerning the tension in the area of bankruptcy taxation. [39] This Roundtable discussion elaborated upon the deficiencies of bankruptcy and tax law and the policy behind insolvency taxation.

Professor Michelle Arnopol Cecil

Professor Michelle Arnopol Celcil is also a prominent bankruptcy taxation scholar in the US that has been researching in this area since the early 1990s. In 2003, she published a paper aimed at unifying competing tax and bankruptcy policies with respect to abandonments in bankruptcy.[40] She expresses that a proper resolution of this issue must necessarily harmonise bankruptcy and tax policy. She comments:[41]

> Legal scholarship in the field of debtor and creditor relations tends to focus exclusively on the bankruptcy aspects of a vexing legal issue; very few scholars have attempted to harmonize the often conflicting bankruptcy and tax policies underlying these issues. Similarly, the congressional committees devoted to addressing tax issues, the House Ways and Means Committee and the Senate Finance Committee, have often been criticized for passing bankruptcy tax measures as part of an overall tax reform bill without consulting or coordinating with their committee counterparts devoted to bankruptcy issues, the House and Senate Judiciary Committees. Thus, neither academic literature nor recent legislation has explored the intersection of these two vast bodies of law.

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[37] Jack F Williams, 'A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, the Bad, and the Ugly' (1997) 5 *American Bankruptcy Institute Law Review* 462.
[38] Steven J Csontos, Carmen R Eggleston, Polly S Higdon, Robin E Phelan, James I Shepard and Jack F Williams, 'Bankruptcy Taxation: Congress's Role in Bankruptcy Tax Policy: A Roundtable Discussion' (1995) 3 *American Bankruptcy Institute Law Review* 257-469.
[39] Ibid.
[40] Michelle Arnopol Cecil, 'Abandonments in Bankruptcy: Unifying Competing Tax and Bankruptcy Policies' (2003) 88 *Minnesota Law Review* (2003) 723-782.
[41] Ibid 748.

Through analysing the issue of how to treat bankruptcy abandonments for tax purposes, she aims to take 'one small step towards harmonising bankruptcy and tax policy'.[42]

Professor Frances Hill

Professor Frances Hill's scholarship has focused on tax law and in particular tax exempt organisations. However, one of her areas of interest is bankruptcy taxation. She has written an article that sets forth certain analytical propositions for a theory of bankruptcy tax.[43] She articulates a statutory coordination approach that is based on bringing tax purposes more fully into the bankruptcy tax discussion. Her approach is to interpret the two (or more) conflicting statutes in light of the purposes of each and the ongoing modification of each in light of the consequences of legislative, regulatory, and judicial efforts to coordinate them.[44]

Developing the Framework for a Corporate Insolvency Taxation Law

Given the ongoing tension in relation to the adequacy of tax revenues and the increase in the rate of corporate insolvencies, it is timely that the intersection of taxation and corporate insolvency law and administrative practices be considered by applying a more appropriate theoretical framework.[45] In order to develop a

[42] Ibid 749.
[43] Frances R Hill, 'Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach' (1996) 50(1) *The Tax Lawyer* 103-180.
[44] Ibid 106.
[45] FCT, *Annual Report 2014-15* (2015) 44; Australian Government, IGT, *'Debt Collection, A report to the Assistant Treasurer'* (2015); Parliament of the Commonwealth of Australia, House of Representatives Standing Committee on Tax and Revenue, *Tax disputes* (2015); Business Council of Australia, *The Future of Tax: Australia's Current Tax System* (2014) 2.

theoretical framework in which to analyse Australian laws and administrative practices with respect to corporate insolvency taxation, the approach adopted in this thesis involves researching the theoretical perspectives of taxation law and then using these perspectives to find a counterpart theoretical perspective in insolvency law. This analysis supports the emergence of a theoretical perspective of corporate insolvency tax that embraces that perspective and sits at the crossroads of the theoretical perspective of tax law and the communitarian's perspective of insolvency law.

The Framework that is developed around this perspective is comprised of five criteria. That is, at the cross-roads of tax law and insovency law sits a corporate insolvency tax system which is aimed at achieving fiscal adequacy, corporate rescue, equity, efficiency and simplicity. Corporate insolvency taxation laws should be aimed at achieving as many of these criteria as possible, and if trade-offs must be made there must be clear and continuous reference to these theoretical perspectives which will offer a means of assessing current legislative provisions and reform proposals in a manner that is legally coherent, commercially efficient and politically acceptable.

Applying the Framework - The Commissioner's Role as a Creditor in a Corporate Insolvency

The literature which considers the role of the Commissioner in a corporate insolvency is predominantly concerned with two issues. The first issue is whether the Commissioner should be given preferred treatment relative to other

creditors.[46] That is, in a corporate insolvency should such claims be paid ahead of other unsecured, and in some cases, also secured claims? The second issue considers the appropriate level of enforcement powers that should be available to the Commissioner in exercising his role in administering the tax law as a creditor in a corporate insolvency.[47]

Australia has removed all statutory tax priorities and therefore there is no priority given to tax claims in insolvency.[48] Accordingly, the Commissioner is an unsecured creditor with respect to those tax claims. While the Commissioner is disadvantaged by being an unsecured, involuntary creditor, there are a number of measures that the Commissioner can take to improve his position over other general unsecured creditors. In that regard, the Commissioner can rely upon a common set of rules in Part 4-15 of Schedule 1 to the TAA 1953 that provide him with considerable powers to administer the tax law. This includes making an assessment of tax liability, and collecting the tax related liabilities and other related amounts owing arising from a valid assessment.

In addition to this legislative scheme, the ATO has provided administrative guidance as to the operation of the legislation by way of Law Administration Practice Statement (PS LA) documents, which prescribe the ATO's view on the operation of the legislative provisions addressed. The manner in which the ATO engages with

[46] See for example David Morrison, 'Never mind the law: Just hurry up and collect more tax! The ATO persists with unnecessary litigation' (2015) 23 *Insolvency Law Journal 196,* 196-208.
[47] See for example David Morrison, 'Why is there a gap in the tax treatment of solvent versus insolvent companies and why does it matter?' (2014) 22 *Insolvency Law Journal* 192, 192-194.
[48] *Insolvency (Tax Priorities) Legislation Amendment Act 1993* (Cth); Helen Anderson, 'Theory and reality in insolvency law: Some contradictions in Australia' (2009) 27 *Company and Securities Law Journal* 506, 507 and 513.

taxpayers in the administration of the legislative scheme can be as important as the content of the legislation itself.[49] In the context of a corporate tax debtor approaching insolvency, the efficacy with which the ATO collects tax debts can significantly impact on a number of stakeholders, including the tax debtor, general creditors, competitors of the tax debtor as well as more broadly impact upon Australia's voluntary tax compliance regime, government policy, commercial enterprise, the provision of services for Australians and the broader economy.[50]

This thesis applies the Framework to answer the following questions:

1. Should the Commissioner have priority in a corporate insolvency?

2. Is there harmony at the intersection of tax law and insolvency law with respect to the Commissioner's debt collection practices in the context of tax administration?

3. Is there harmony at the intersection of tax law and insolvency law with respect to the Commissioner's powers to issue:

    a. notices under section 260-5 of Schedule 1 to the TAA 1953?

    b. director penalty notices under Division 269 to Schedule 1 of the TAA 1953?

    c. statutory demand notices under section 459E of the Corporations Act?

[49] Australian Government Productivity Commission, *'Regulator Engagement with Small Business'*, Research Report (2013) 86.
[50] See the discussion of Catherine Brown, Colin Anderson and David Morrison as to the impact of taxation generally on redistribution of wealth, the economy and the broader community in 'The certainty of tax in insolvency: Where does the ATO fit?' (2011) 19 *Insolvency Law Journal* 108, 120.

Thesis Significance

This thesis offers the Framework as a new and complementary tool in assessing whether a law with respect to both tax law and insolvency law is effective. Further, where a law is considered to be ineffective, the Framework can be used to consider possible law reform options. This thesis applies the Framework in relation to one area that sits at the intersection of tax law and insolvency law, being the role of the Commissioner as a creditor in a corporate insolvency with respect to the Commissioner's debt collection powers under the tax law and the Commissioner's debt collection practices in the context of tax administration. However, it is intended that the Framework has far broader application and can be used in relation to analysing the effectiveness of any law that sits at the intersection of tax law and insolvency law.

Secondly, as discussed in the literature review, with respect to contributions to research in Australia, there have been some limited studies in the area of the intersection of tax law and insolvency law, however no research to date has developed and applied a theoretical framework to the area of corporate insolvency taxation law. This thesis will contribute to the areas of tax law and insolvency law and specifically make a contribution to the overall assessment of the effectiveness of the current regime in relation to the role of the Commissioner as a creditor in a corporate insolvency.

Thesis Limitations

There are a number of limitations to this thesis that may draw out implications for future studies. The first limitation is that this thesis analyses the role of the Commissioner as a creditor in a corporate insolvency with regard to only a select number of powers that the Commissioner can utilise under the TAA 1953. Accordingly, there are a number of additional powers available to the Commissioner under the TAA 1953 as well as other federal taxation legislation to recover outstanding tax debts that have not been analysed in this thesis.[51] Further, there are a number of additional areas at the intersection of tax law and insolvency law that have not been examined in this thesis. For example, the tax status of an entity under insolvency administrations, the tax obligations of external administrators, share capital restructuring, share disposals and distributions on liquidation, transactions involving debts, debt reconstructions, carry forward of deductions for losses and bad debts, asset valuation and depreciation, capital gains tax (CGT) issues and GST and insolvency. An examination of these additional areas would warrant separate theses.

The second limitation is that this thesis only analyses the role of the Commissioner in a corporate insolvency in Australia with limited discussion of the international experience. Future comparative studies may enable academics and practitioners to gain a better understanding through more in-depth research and analysis of how

[51] For example, under Part 4-15 of Schedule 1, the Commissioner has rights of recovery against liquidators and receivers, may make an estimate of unpaid amounts of a PAYG withholding or SGC liability and recover the amount of the estimate, can issue a notice to provide information, subject the taxpayer to criminal and civil penalties and issue the taxpayer a departure prohibition order.

the role of revenue authorities in insolvency are viewed and treated globally from both a legislative and administrative perspective. An examination of other jurisdictions in this manner would warrant a separate thesis.

The third limitation is that this thesis focuses exclusively on legal considerations in forming the law and administrative reform proposals, with a very limited examination of economic considerations. In that regard, this thesis does not provide an in-depth economic analysis of the impact of tax on corporate tax debtors and other key stakeholders in Australia. An in-depth economic analysis is required in future studies to assess the true extent and impact of the actions of the Commissioner in a corporate insolvency upon the tax debtor and other key stakeholders, and how any adverse economic impact might be negated.

Conclusion

Before we can consider the current laws that may be used by the Commissioner against a corporate tax debtor in Australia, it is necessary to investigate the optimal theoretical framework in which to assess the effectiveness of these laws in Australia. This thesis will apply this theoretical framework to the current legal and administrative framework in order to identify the deficiencies in the current law and to propose options for law reform.

Chapter 2 - Theoretical Perspectives of Australian Tax Law

Introduction

The primary consideration of any tax system is whether the tax system is meeting the objectives that have been set for it and if not, whether a better tax system could be introduced.[52] Tax policy covers a whole range of areas including determining the most appropriate tax base, setting policy objectives, the legislative framework and its administration.[53] It is clear that in deciding the best overall tax system and in deciding between the alternative provisions in particular taxes that a theoretical, policy based approach is preferable as it assists in shaping and developing the tax system in a methodical and coherent manner. This approach has been supported by each of the major tax reviews that have occurred in Australia, and most recently, it was the approach taken by the Henry Review.[54]

This chapter reviews the overarching principles that have laid the foundations for each of the major Australian tax reviews that have occurred since Federation. This review reveals that the principles of fiscal adequacy, equity, efficiency and simplicity are the fundamental criteria upon which any policy based approach to Australian tax law design must be based. An inquiry into the meaning of each of these seemingly simple principles highlights that trade-offs between the socio-

[52] See for example Nicole Wilson-Rogers and Dale Pinto, 'Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes' (2009) 7(1) *eJournal of Tax Research* 72, 78 in which the authors discuss the Australian Government's utilisation of tax policy to influence economic objectives such as gold mining between 1924 to 1988.
[53] Australian Treasury, *Review of Business Taxation, A Strong Foundation, Establishing framework objectives and principles*, Discussion Paper (1998) 61-62, 68, 71-81.
[54] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 102.

economic goals of equity, efficiency and simplicity often need to be made. Finally, an assessment will be made as to whether these tax policy criteria compel a clear answer as to whether corporate tax debtors should be dealt with under the general law in the same manner as all other tax debtors or whether there should be any departure from general tax principles in a corporate insolvency.

Tax Law – A Public Law

Tax law is public law defining the terms of the government's collection of revenue from tax-paying citizens.[55] Collecting tax is a sovereign activity distinguishing the government from a private creditor.[56] In that regard, tax law does not in the first instance define the relationship of one citizen to one or more other citizens in their private capacities as borrowers, lenders, purchasers, or sellers.[57]

Public law values, underpinned primarily from administrative law include openness, fairness, participation, impartiality, accountability, honesty and rationality. [58] These public law values seek to ensure that the decisions of

[55] John Snape, *The political economy of corporation tax: Theory, values and law reform* (Bloomsbury Publishing, 2011).
[56] See the discussion regarding the government's advantageous position as a public creditor in contrast to that of private creditors in Barbara K Day, '"Better than Nothing": Limiting the Priority for Taxes in Insolvency to Enhance Unsecured Creditor Recoveries' (2006) *International Insolvency Institute* 3, 4.
[57] Morton J. Horwitz, 'The History of the Public/Private Distinction' (1982) 130(6) *University of Pennsylvania Law Review* 1423-1428. 'Tax provides a fascinating example of the emergence of the public/private distinction. As late as the sixteenth century, English judges still analysed tax, not as an exaction by the state but as a private gift from the donor-the taxpayer. Parliament was thought to have simply arranged this consensual private transaction. Only with the development of theories of sovereignty in the seventeenth century did tax begin to be understood as part of public law.'
[58] Carol, Harlow, 'Global Administrative Law: The Quest for Principles and Values' (2006) 17(1) *European Journal of International Law* 187-214.

government that affect the vital interests of the public are made through accountable and participatory processes.[59]

In the context of tax law, these public law values are reflected by setting fundamental principles which underpin tax policy and tax reform.[60] Accordingly, any framework for corporate insolvency tax must thus take account of these public law elements of tax law.

Fundamental Principles That Underpin Tax Policy: A Historical Perspective

Seeking an overarching principle or principles for tax policy is not a new phenomenon. One early attempt was taken by Jean-Baptiste Colbert, the Controller-General of Finances of France under Louis XIV who described the '[t]he art of taxation' as consisting of 'plucking the goose so as to obtain the largest amount of feathers with the least possible amount of hissing.'[61]

The most frequently quoted is that of Adam Smith, regarded as the 'Father' of economics who produced four functional criteria for assessing a tax system:[62]

1. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

[59] Ibid.
[60] Australian Treasury, *Review of Business Taxation, A Strong Foundation, Establishing framework objectives and principles*, Discussion Paper (1998) 61.
[61] As referred to by United Kingdom, House of Commons, Treasury Committee, *Principles of taxation policy*, Eighth Report of Session 2010–11, Volume I (2011); Additional written evidence is contained in United Kingdom, House of Commons, Treasury Committee, *Principles of taxation policy*, Eighth Report of Session 2010–11, Volume II (2011).
[62] Adam Smith, *'An Inquiry into the Nature and Causes of the Wealth of Nations'* (1776), Book 5, Chapter 2, Part II 'Of taxes'.

2. The taxation which each individual is bound to pay ought to be certain, and not arbitrary.

3. Every taxation ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

4. Every taxation ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.

Accordingly, since the 1700s, there have been many attempts to establish a fundamental set of principles that can be used to objectively assess the tax system and new tax policy proposals.[63]

Australian Tax Reviews

Conducting reviews of the Australian tax system has been a policy agenda of the government since the time that the Commonwealth enacted its first federal tax law in 1915. Since this time, reviews of the tax system have been conducted by Parliamentary committees and government-appointed officials or bodies including the Australian National Audit Office, the Inspector General of Taxation (IGT) and the Board of Taxation. Reviews of the Australian tax system are considered to be an appropriate and desirable policy of government in Australia.[64] In Australia, there have been a number of tax reviews which have considered the fundamental principles upon which the Australian tax system should be based.

[63] See for example the commentary of Justin DuRivage and Claire Priest on the policy and purpose of the *Stamp Act 1765* in 'The Stamp Act and the political origins of American legal and economic institutions' (2015) 88 *Southern California Law Review* 875.

[64] Australian Treasury, Taxation Review Committee*, Full Report* (1975). As the Asprey Committee observed, '[e]ven if, as is not the case, the Australian system were generally agreed to be as satisfactory as any tax system is ever admitted to be, a periodic thorough inspection would be as wise a precaution in this area of affairs as in any other'.

Particular aspects of the Australian tax system have been examined by a number of independent committees including the Kerr Royal Commission (1920–23),[65] the Ferguson Royal Commission (1932–34),[66] the Mills Committee (1942),[67] the Spooner Committee (1950-1954),[68] the Hulme Committee (1954-1955),[69] the Ligertwood Committee (1959-1961),[70] the Mathews Committee (1974-1975),[71] the Campbell Committee (1979-1983)[72] and the Ralph Review (1989-1999).[73]

There have been two reviews of the overall tax system which produced the Asprey Report (1972–75)[74] and the Henry Review Report (2008–09)[75] and two Government-led reviews conducted by the Department of Treasury which produced the Draft White Paper (1985),[76] the Information Paper (1989)[77] and the

[65] Royal Commission on Taxation (Kerr Commission), *First Report, Together with Appendices* (1921); Royal Commission on Taxation (Kerr Commission), *Second Report, Together with Appendices* (1921); Royal Commission on Taxation (Kerr Commission), *Third Report* (1922); Royal Commission on Taxation (Kerr Commission), *Fourth Report* (1923); Royal Commission on Taxation (Kerr Commission), *Fifth and Final Report, Together with Appendices* (1923).

[66] Royal Commission on Taxation (Ferguson Commission), *First Report* (1933); Royal Commission on Taxation (Ferguson Commission), *Second Report* (1934); Royal Commission on Taxation (Ferguson Commission), *Third Report* (1934); Royal Commission on Taxation (Ferguson Commission), *Fourth and Final Report* (1934).

[67] Committee on Uniform Taxation, *Report of the Committee on Uniform Taxation* (1942).

[68] Commonwealth Committee on Taxation (1950); The Treasurer referred over 50 particular matters to the Committee from 1950 to 1954. See Graham Hill, 'Taxation Reform: A Tower of Babel; Distinguishing Taxation Reform from Taxation Change' (2005) 1(2) *Journal of the Australasian Taxation Teachers Association* 1-24.

[69] Commonwealth Committee on Rates of Depreciation, *Report of the Commonwealth Committee on Rates of Depreciation* (1955).

[70] Commonwealth Committee on Taxation, *Report on the Commonwealth Committee on Taxation* (1961).

[71] Committee of Inquiry into Inflation and Taxation, *Inflation and Taxation* (1975).

[72] Committee of Inquiry into the Australian Financial System, *Report of the Committee of Inquiry into the Australian Financial System* (1983).

[73] Review of Business Taxation, *'A Taxation System Redesigned'* (Canberra, 1999).

[74] Australian Treasury, Taxation Review Committee*, Full Report* (1975). This was an external review.

[75] [75] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 102. The Henry Review was not totally external, as it was chaired by the Secretary to the Treasury.

[76] Australian Treasury, *Reform of the Australian Taxation System* (1985).

[77] Australian Treasury, *Taxation of Foreign Source Income: An Information Paper* (1989).

ANTS Report (1998).[78] Additionally, there is a volume of supporting material by way of Commissioner Studies and Treasury Taxation Papers in relation to a number of these reviews.[79]

While there have been numerous tax reviews in Australia, the major reforms to the Australian tax system occurred during the last 15 years of the 20th century.[80] Many of these reforms have derived from the recommendations of the Asprey Report.[81] Accordingly, the fundamental principles that have driven these more recent Australian tax reviews, including the Asprey Report, will be considered in the following discussion.

Asprey Report

In response to the wide-spread public dissatisfaction over the nature and direction of tax in Australia, the Government of Prime Minister William McMahon appointed the Asprey Committee in 1972.[82] This was to be the first full-scale review of the Commonwealth tax system since the Royal Commission on Taxation, reported in 1934.[83] As part of the review, the Australian Treasury published a number of papers dealing with aspects of the Australian Government tax structure which were submitted by the Treasury to the Asprey Committee during 1973 and 1974. These

[78] Australian Treasury, *Taxation Reform: Not a New Taxation, a New Taxation System* (1998).
[79] For example, in relation to Mathews Committee (1974-1975) see Australian Treasury, Taxation Review Committee, *Commissioned Studies* (1975) and Australian Treasury, *Treasury Taxation Papers (Nos. 1 to 15)* (1974-1975).
[80] Hon Justice Richard Edmonds, 'Critique and Comment, A Judicial Perspective on Tax Reform' (2011) 35 *Melbourne University Law Review* 241.
[81] Ibid; Chris Evans and Richard Krever, 'Editorial: Tax reviews in Australia: A short primer' (2009) 38 *Australian Tax Review* 69, 72.
[82] Norman J. Thomson, 'Taxation and the Asprey and Mathews Reports' (1976) 48(4) *The Australian Quarterly* 76, 78.
[83] Commonwealth, *'Report of the Royal Commission on Taxation'* (Canberra, 1932-34).

papers provided factual and analytical material on the operation of the tax system, and the extent to which it met the objectives which it must serve in the Australian context.[84]

The Australian Treasury described six characteristics which it considered to be essential in a tax system which were the ability to meet revenue needs, fiscal flexibility, equity, neutrality, economic efficiency and growth and administration.[85] These characteristics were guiding principles and objectives which were intended to assist in the derivation of a coherent pattern when considering the vast number of provisions in Australia's tax system.[86]

The Asprey Report was produced in January 1975 after extensive public consultation.[87] The Asprey Report considered that Australian tax policy should serve the dual goals of raising revenue and shaping socio-economic policy. The Asprey Report highlighted the fiscal importance of the tax system by stating that '[t]he Committee is directed to carry out its review of the existing taxation system in the light of the need to ensure a flow of revenue sufficient to meet the revenue requirements of the Commonwealth'[88] and that the 'Committee is prohibited from suggesting any general set of measures that would necessarily reduce total taxation below revenue needs.'[89]

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[84] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) piii.
[85] Ibid.
[86] Ibid.
[87] Australian Treasury, Taxation Review Committee*, Full Report* (1975) xviii. The Committee received in all 605 written submissions and had the opportunity of conference and discussion with certain authors of submissions.
[88] Ibid 11.
[89] Ibid.

In relation to tax policy achieving its socio-economic policy goals, the Committee referred to the first of the more positive commands in its Terms of Reference in conducting its review, which directed the Committee to consider the effects of the tax system 'upon the social, economic and business organisation of the community'.[90] The Committee considered this to be 'a phrase with multiple connotations' and considered it 'helpful to separate these out and attach them to other rather more specific injunctions'.[91] In that regard, the Committee considered the effects of the taxation system upon the 'economic and efficient' use of resources of Australia, the desirability that there should be a 'fair distribution of the burden of taxation', and that revenue-raising be 'by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense'.[92] These aims were referred to in the report as efficiency, fairness and simplicity.

While equity, efficiency and simplicity were the Committee's three dominant tests of merit for both individual taxes and the tax system as a whole, there were two other objectives that the Committee also considered worthy of mention. Firstly, flexibility in the tax system was a characteristic the Committee believed was of obvious importance to economic management or stabilisation.[93] Secondly, economic growth was another objective that the Committee believed, in the view of some, should be deliberately and distinctively pursued in tax policy.[94]

[90] Ibid 12.
[91] Ibid.
[92] Ibid.
[93] Ibid 17.
[94] Ibid.

Draft White Paper

During the 1984 election campaign, Prime Minister Robert Hawke delivered the promise that if re-elected, his Government would prepare a policy paper of tax reform which would be consulted upon and implemented later in his parliamentary term.[95] Subsequent to the campaign, Hawke was re-elected to his second term in office between 1984 and 1987, and he followed through with his election promise. This period was one of intense tax reform debate that was described by one political commentator as 'one of the most intense public policy debates in Australian history'.[96]

The introductory chapter to the Draft White Paper noted that the post-war trend in all advanced countries had been towards the provision of more widespread government services such as pensions, health and education services and community infrastructure.[97] The Government stated that satisfying those demands meant that for 'many years' the overall burden of tax had increased under successive governments.[98] While the need to meet fiscal adequacy requirements was acknowledged, one of the principles stated by the Prime Minister at the National Tax Summit Conference in July 1985[99] (and expressed in the Draft White Paper) was that there would be 'no increase in the overall taxation burden, as measured by the share of Commonwealth government taxation revenue in gross

[95] Robert Hawke, Australian Labor Party, 'Election Speech' (Speech delivered at Sydney, NSW, 13 November 1984).
[96] Paul Kelly, '*The End of Certainty*' (Allen & Unwin, 1992) 155.
[97] Australian Treasury, *Reform of the Australian Taxation System* (1985) 1.
[98] Ibid.
[99] Australia, *'A Guide to Tax Reform: A Guide to the Government's Draft White Paper on Tax Reform'*, presented to the National Taxation Summit Conference, July 1985 (Canberra, 1985).

domestic product through the government's current term in office'. [100] Accordingly, it is apparent that there was not as much focus on the tax system's revenue-raising function as there was in the Asprey Report, and that there was greater emphasis on achieving the socio-political factors.

The Draft White Paper considered the essential criteria for assessing a tax system to be equity, efficiency and simplicity. It considered an equitable tax system to be 'critical, not only to the attainment of economic and social objectives, but also to the maintenance of a basic respect for the taxation system from which a high degree of voluntary compliance derives'. [101] In that regard, the introductory statements to the Draft Paper stated that it attached particular importance to achieving a fairer sharing of the tax burden.[102] A more efficient tax system was considered to be 'necessary in order to improve Australia's economic performance. With a more efficient taxation system, resources would be more likely to move into activities where they would generate the largest economic gains to the nation, rather than activities where they would simply yield the largest taxation gain to investors'.[103] Further, a simpler tax system was considered to be essential so that the law could be 'understood by the people to whom it applies'. A simpler tax system also meant that 'fewer resources will be devoted to socially unproductive activities such as taxation planning and taxation litigation'.[104]

[100] Ibid 2.
[101] Ibid 14.
[102] Ibid.
[103] Ibid.
[104] Ibid.

The Draft White Paper provides that while 'equity, efficiency and simplicity are the traditional and fundamental criteria against which all taxation systems must be measured, there are a number of additional, and in some instances more specific factors that must be considered in evaluating a taxation system, and in particular the Australian taxation system'. These included the need to prevent tax avoidance and evasion, to recognise the impact of inflation on the tax system, to review government spending programs in the tax system and for harmonisation of federal, state and local tax systems. [105]

Tax Reform: Not a new tax, a new tax system (ANTS Report)

Similar in tone to the 1984 election campaign, Prime Minister John Howard and Treasurer Peter Costello opened the 1998 election campaign by announcing 'the biggest single remake of the Australian tax system since Federation'.[106] When re-elected, Howard brought together 30 specialists from Treasury, the ATO, the Social Security department and the Prime Minister's department to work on developing a tax reform package.[107]

In relation to the tax system's fiscal adequacy requirement, the ANTS Report noted that the current tax system was ineffective.[108] In that regard, the ANTS Report stated that the tax system 'provides a crumbling base from which to derive the necessary revenue to fund essential government services, including those provided

[105] Ibid 15-17.
[106] Australian Government, *'Your History, Our Story, Australia's Prime Ministers'*, available at http://primeministers.naa.gov.au/primeministers/howard/in-office.aspx last accessed 18 March 2016.
[107] Ibid.
[108] Australian Treasury, *Taxation Reform: Not a New Taxation, a New Taxation System* (1998) 6.

to rural and regional areas as well as those provided through the social security system.'[109] Accordingly, this revenue-raising criteria represented an important driver of the initiatives that were to be implemented as part of the ANTS reforms.

In relation to the attainment of the socio-economic goals in the tax system, the ANTS Report provided that what was being proposed was 'a new taxation system that has as its central priorities not only the efficiency and effectiveness of our national economic policy framework but also the sense of equity and fairness that has always been part of the Australian way.'[110]

The Government's tax reform plan built on four pillars to achieve a fairer tax system. These included incentive, security, consistency, and simplicity.[111] Unlike Australia's other tax reviews, the ANTS Report does very little to define each of the four pillars, but simply discusses the tax reform initiatives the Government intended to introduce in order to achieve its four pillar objective. The Government provided the following brief description of each of the pillars:[112]

> Incentive: a fairer taxation system with greater reward for effort. In that regard, the Government's aim is that the new taxation system will be fairer and provide stronger incentives to work and save.
>
> Security: sounder finances for government services. This pillar is intended to deliver a taxation system with higher economic growth through more competitive Australian exports and import competing products, as well as through higher investment driven by lower industry costs.
>
> Consistency: a taxation system which boosts business and investment, and promotes Australian exports.
>
> Simplicity: making the taxation system easier to deal with.

[109] Ibid.
[110] Ibid v.
[111] Ibid 13.
[112] Ibid 13-16.

In this regard, the ANTS Report based its 'new tax system' on the essential criteria of fiscal adequacy, equity, efficiency and simplicity as well as the additional criteria of economic growth. Accordingly, the fundamental principles upon which the ANTS Report was based were not dissimilar to that of the Asprey Report 20 years earlier.

Henry Review

The Australia's Future Tax System Review, informally known as the Henry Review after its chairman, Treasury Secretary Ken Henry, was commissioned by the government of Prime Minister Kevin Rudd in 2008 and was published in 2010.[113] The Henry Review Committee was asked to examine the current tax system and 'make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century'.[114]

In relation to previous tax policy criteria adopted in Australia, the Committee noted '[w]e find that much of the key architecture of the existing taxation and transfer system, built last century, reflects sound policy frameworks and Australian social values and will still serve us well. But not all of it will — a range of key reforms would even better equip us for the changing era ahead.' [115]

The Recommendations made in the Henry Review were based upon five design principles for the tax and transfer system which included equity, efficiency, simplicity, sustainability and policy consistency.[116]

[113] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) ii-iii.
[114] Ibid vii.
[115] Ibid xv.
[116] Ibid 17.

Fiscal adequacy was considered to be the primary objective of the Henry Review with the Committee stating that the Government's revenue-raising objective 'should not be compromised by other policy objectives'.[117] However, the Terms of Reference also recognised the importance of the socio-economic criteria by stating that 'raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational) and to minimise complexity for taxpayers and the community'.[118]

In addition to those three policy drivers, sustainability and policy consistency were also considered to be overarching principles upon which the Henry Review considered Australia's tax system should be based. The characteristic of sustainability as described by the Henry Review was also a fundamental principle of the Australian Treasury which referred to this characteristic as fiscal flexibility.[119] It was also one of the fundamental principles driving the Asprey Report, which referred to this principle as economic management or stabilisation.[120] Further, the aim of policy consistency was also one of the fundamental principles driving the ANTS review of Australia's tax system.[121] Accordingly, upon reviewing these major reviews of Australia's tax system, there appears to be considerable consistency as to the fundamental principles upon which Australia's tax system should be based.

[117] Ibid 17.
[118] Ibid vii.
[119] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) piii.
[120] Ibid 4; Australian Treasury, Taxation Review Committee*, Full Report* (1975) 17.
[121] Australian Treasury, *Taxation Reform: Not a New Taxation, a New Taxation System* (1998) iii.

The International Perspective

The policy criteria of fiscal adequacy, equity, efficiency and simplicity, which have been central to the Australian tax system, have been universally recognised as being the fundamental criteria upon which many OECD jurisdictions base their tax systems.[122]

In relation to the fiscal adequacy requirement, one recent World Bank/PwC report on *Paying Taxes* stated '[t]axes are essential. In most economies the taxation system is the primary source of funding for a wide range of social and economic programmes. How much revenue these economies raise through taxes will depend on several factors, including the government's capacity to raise revenue in other ways, such as rents on natural resources.'[123]

In the international context, one OECD study considering the general principles guiding tax policy stated:[124]

> Three features of taxation are especially important. First, so long as taxation affects incentives it may alter economic behaviour of consumers, producers or workers in ways that reduce economic efficiency. These effects should be taken into account when the costs and benefits of public expenditure to be funded are being assessed.
>
> Second, the distribution of taxation's impact across the population raises issues of equity, or fairness, which must be given substantial weight even if it entails costs in terms of economic efficiency. Third, the practical enforceability of taxation rules and the costs arising from compliance are important considerations, the more so since these are both affected by, and have implications for, the efficiency and public perceptions of the fairness of taxation systems. As elaborated in more detail below, the key challenge for taxation policy is to strike the best possible balance among these issues.

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[122] OECD Tax Policy Studies, '*Fundamental Reform of Personal Income Tax*', No. 13, (Paris, 2006) Ch 2.

[123] Pricewaterhouse Coopers and World Bank Group, *Paying Taxes 2011, The Global Picture* (2011) 7.

[124] OECD, *Tax and the Economy, A Comparative Assessment of OECD Countries,* Taxation Policy Studies No.6 (2001) 17.

Accordingly, using these policy criteria to assess the effectiveness of the tax system or a tax law has international acceptance.

Policy Criteria for Australia's Tax System

As a result of analysing the fundamental principles that have driven Australia's tax reviews during the previous 25 years, it is clear that in deciding the best overall tax system and in deciding between the alternative provisions in particular taxes, that seeking to achieve these overarching principles has traditionally guided the development of Australia's tax system.[125]

This thesis will focus on the principles of fiscal adequacy, equity, efficiency and simplicity as the fundamental criteria upon which any theoretical policy based approach to Australian tax law design must be undertaken. The preceding discussion of Australia's tax reviews clearly justifies adopting this approach as these are the fundamental principles that have underpinned each of Australia's tax reviews. Hence, it is appropriate to consider further the meanings of these seemingly simple terms with regard to what has been said about these principles in each of these Australian tax reviews.

Fiscal Adequacy

Fiscal adequacy was defined by the Australian Treasury as 'the government's ability to meet revenue needs'.[126] This principle was considered to be the 'primary

[125] Nicole Wilson-Rogers and Dale Pinto, 'Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes' (2009) 7(1) *eJournal of Tax Research* 72, 72-75.
[126] OECD, *Tax and the Economy, A Comparative Assessment of OECD Countries,* Taxation Policy Studies No.6 (2001) 10.

requirement' of the Australian Treasury in 1974[127] and of the resulting Asprey Report,[128] and most recently the 'primary objective' of the tax system in the Henry Review.[129]

With fiscal adequacy requirements in mind, the Australian Treasury noted that one option would involve reconsidering the exemptions and concessions in the tax laws, with the aim of enlarging the tax base.[130] The Asprey Report commented that 'a taxation concession to a particular area of spending in the private sector can as well be looked upon as an expenditure of revenue as a failure to collect it'. It then commented that 'it is often an issue of importance to taxation policy whether such concealed subsidies should not better be given overtly'.[131]

The Australian Treasury noted that another option to satisfy its fiscal adequacy objective was to consider new forms of tax, and to look particularly at forms of tax which other countries use but that Australia does not have.[132]

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[127] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 3.
[128] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 11.
[129] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.
[130] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 3.
[131] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 11.
[132] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 3-4.

Equity

The Asprey Report stated that equity is the 'most universally sought after of qualities in individual taxes and taxation systems as a whole'.[133] The Henry Review defined the principle of 'equity' as follows:[134]

> The taxation and transfer system should treat individuals with similar economic capacity in the same way, while those with greater capacity should bear a greater net burden, or benefit less in the case of net transfers. This burden should change more than in proportion to the change in capacity. That is, the overall system should be progressive. Considerations about the equity of the system also need to take into account exposure to complexity and the distribution of compliance costs and risk.

This definition of 'equity' is customarily distinguished into the two dimensions of 'horizontal' and 'vertical' equity.[135] Horizontal equity is achieved when people who are equally placed have equal tax burdens, while vertical equity is achieved when the more well-to-do have greater tax burdens than those less fortunately placed. Both of these expressions reflect the 'ability to pay' principle.[136]

The third dimension of intergenerational equity was introduced by the Henry Review.[137] While no definition was given in the review of intergenerational equity, an example was provided in relation to road investment. The example concerned long life of road investments and provided that 'if investment in road networks is directed to meet anticipated future needs, then debt, to be repaid by future

[133] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 15.
[134] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.
[135] Australian Treasury, *Reform of the Australian Taxation System* (1985) 14.
[136] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 12.
[137] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 396-397.

generations, might be a more equitable source of finance than charges imposed on today's users'.[138]

A number of Australia's tax reviews have noted that what 'equity' means in practice is problematic and is the subject of endless contention and debate. The Australian Treasury noted that the reason for this is due to 'equity' being intangible or non-measurable which leads to any definition of this term being open to subjective attitudes and opinion.[139]

The Australian Treasury noted that when looking at horizontal equity there were a number of questions that needed to be answered to determine when people are 'equally placed'. For example, should the idea have regard only to taxpayer's total income, or should it also have regard to its composition? Should it have regard to assets and all capital gains? Should it look to the total income of a family, regardless of the number of income-earners, to that of husband and wife or to the income of each individual? [140] In considering vertical equity, the Australian Treasury commented that these questions are relevant as well as additional questions such as the rate at which taxes should increase with capacity to pay. This question is asking what degree of progression the tax system should impose, which gives rise to widely differing views.[141] Even if all of the questions above could be answered, the Australian Treasury commented that there was a third layer of questions which had to be resolved to determine the extent to which the tax system is equitable.

[138] Ibid.
[139] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 4.
[140] Ibid 4-5.
[141] Ibid 5.

These included, who finally bears the various taxes? Which taxes are wholly passed on, which are partially passed on and which are not passed on at all?[142]

The Asprey Report added perhaps what can be seen as another layer to the complexity. In that regard, the Asprey Report made the point that 'when we say that persons in equal situations should pay the same taxation we probably say so because we think of the taxation as a sacrifice levied upon some kind of private "economic well-being". Once this is accepted, then it is usually taken for granted that the best available measure of an individual's well-being is income'.[143] The Asprey Report highlighted that there remained 'very great difficulties in finding an exact and workable definition of "income" for taxation purposes, as the length of the *Income Taxation Assessment Act* and its frequent amendment testify'.[144]

In relation to achieving an equitable tax system, the Draft White Paper noted:[145]

> Although there can be no definitive answers to these questions, there is wide agreement that a fair taxation system (which achieves horizontal and vertical equity) is unlikely to be achieved without a comprehensive taxation base. If certain types of income are omitted from the taxation base, or if particular expenditures are treated preferentially, then taxpayers with similar taxpaying capacities will not be taxed equally.

In relation to achieving vertical equity, the Draft White Paper stated that 'since deviations from a comprehensive taxation base generally accrue to the benefit of high income individuals, defining the taxation base comprehensively is necessary for the achievement of vertical equity'.[146] Accordingly, the Draft White Paper

[142] Ibid.
[143] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 13.
[144] Ibid.
[145] Ibid.
[146] Ibid.

echoed many of the difficulties and concerns in defining an equitable tax system which were considered by the Australian Treasury and the Asprey Report.[147]

Economic Efficiency

The Asprey Report commented that 'economic and efficient use of national resources is a long standing and by now most conventional objective of public policy'. [148] The Henry Review defined efficiency as follows: [149]

> The taxation and transfer system should raise and redistribute revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs. All taxes and transfers affect the choices people and businesses make by altering their incentives to work, save, invest or consume things of value to them. The size of these efficiency costs varies from taxation to taxation and from transfer to transfer, reflecting, in part, the extent to which they affect behaviour. Instability in policy settings can reduce economic efficiency by increasing uncertainty about the expected payoffs to long-term decisions such as investing in education, choosing retirement products, investing in long-lived productive assets and the choice of business structure. These costs represent a net loss to society as a whole, whereas revenue raised through a taxation is redistributed among members of society through government expenditure, including transfer payments.

Within the aim of efficiency, all government tax reviews have focused on the additional aim of achieving a neutral tax system.[150] In fact, the Asprey Report stated that 'neutrality should be the general aim when efficiency is under consideration' and the Australian Treasury included neutrality as a principle distinct from efficiency as deserving special mention, stating that 'the importance of

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[147] Australian Treasury, *Reform of the Australian Taxation System* (1985) 14.
[148] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 16.
[149] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.
[150] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 5-6; Australian Treasury, Taxation Review Committee*, Full Report* (1975) 16. Although the Draft White Paper, ANTS Report and Henry Review do not mention the term 'neutrality' when discussing the criteria for tax reform, the principle of neutrality is discussed under the 'efficiency' criteria in each of these tax reviews.

"neutrality" as the basis for an efficient and equitable taxation system, with minimum scope for abuse, can hardly be stressed enough.'[151]

The definition of neutrality is perhaps best described by the Draft White Paper which states that '[i]n so far as it can be presumed that, left to their own devices, individuals will spend their incomes wisely, and business will choose the most efficient means of production, the minimisation of waste requires that the taxation system should not influence individual and business choices.'

In a business context, the Asprey Report stated that in order for the tax system to be neutral 'it should not interfere with the relative returns from different modes of investment, it should not alter the relative attractiveness of different types of business organisation, or the relative prices of productive resources and it should not discriminate between different types of production'. [152]

The Australian Treasury listed the following undesirable consequences which result from a tax system that is lacking neutrality:[153]

- Possible inequities in the treatment of different groups of taxpayers. For example, exemptions, rebates and other concessions can enable eligible taxpayers to reduce their taxation relative to that of other taxpayers.

- Departures from neutrality, whether in the form of concessions or lack of alignment between different taxes, are some of the principal building blocks

[151] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 6.
[152] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 16.
[153] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 5-6.

which so-called 'taxation planners' use to erect schemes of (legal) taxation avoidance, often of a highly artificial kind.

- Departures from neutrality can also lead to a redirection of resources from one activity to another, purely to obtain a taxation advantage. The real return, and the return to the nation, may be less from the activity to which they are redirected, but 'transfers' to the taxpayer concerned through the taxation system at the expense of the taxpayers in general may lift the private benefit sufficiently to make it worthwhile for the individual taxpayer.

- In some cases the action taken to secure an immediate taxation benefit can in the long run harm not only the nation but also the taxpayers concerned. For example, if a company chooses to use debentures rather than shares for capital raising purposes to a larger degree than it would have if there were no difference in their taxation treatment, it could get into difficulty through its use of an inappropriate gearing ratio if business conditions take a turn for the worse.

While neutrality is considered to be an important general objective, the Australian Treasury acknowledged that some intentional departures from neutrality are necessary in order to influence, in ways desired by the Government, business behavior and the allocation of resources.[154] These comments in relation to departures from neutrality were endorsed by the Asprey Report, but in a very limited manner.[155]

[154] Ibid 5.
[155] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 12-15.

Simplicity

The Asprey Report considered simplicity as the 'second most universally sought after of qualities in individual taxes and taxation systems as a whole' and stated that this principle points to a complex of ideas.[156] This principle was considered in each Australian tax review. The Australian Treasury referred to this principle as 'administration'.[157] The Henry Review defined simplicity as follows: [158]

> The taxation and transfer system should be easy to understand and simple to comply with. A simple and transparent system makes it easier for people to understand their obligations and entitlements. People and businesses will be more likely to make the most beneficial choices for themselves and respond to intended policy signals. A simple and transparent system may also involve lower compliance costs for taxpayers and transfer recipients.

The Asprey Report discussed two further aspects of simplicity which it believed required specific mention. The first was that when complex operations are required for the taxpayer to determine their tax liability, it is desirable that the calculation already needs to be performed for private purposes unconnected with taxation. [159] The Asprey Report noted that while this point is obvious, it is often forgotten.[160] The second observation of the Asprey Report was considered to be 'perhaps even more obvious and even more frequently forgotten. That is, the fewer, per million dollars raised, are the individuals or organisations from whom taxation is collected the simpler is a taxation system'. It gave the pertinent analogy that 'the sheikdom that can raise all the revenue it requires (and maybe much

[156] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 15.
[157] Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 7.
[158] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.
[159] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 15.
[160] Ibid.

more) from a single taxation on a single oil company has what is unquestionably the simplest taxation system of all.'[161]

Weighting the Tax Policy Criteria

The preceding analysis of Australia's tax reviews highlights that fiscal adequacy has been the principal driver of Australia's tax system, followed by the three fundamental principles of equity, simplicity and efficiency. This point is perhaps articulated best in the Asprey Report which stated that 'once revenue requirements were set there was no scope at all for reducing the total taxation' and that '…once fiscal adequacy requirements were set, it was the Committee's task in assessing the arguments offered to ask where the taxation forgone could be recouped more fairly, more simply and more efficiently.'[162]

The Asprey Report recognised the potential for conflict between the principles of equity, simplicity and efficiency and stated that:[163]

> In general it does not appear that, in practice, the conflict between simplicity and efficiency need be very great. Certainly when the latter can be interpreted as mainly requiring neutrality, reliance upon a very simple taxation, a broad-based taxation at uniform rates on all goods and services used in consumption, would produce a taxation system that was simple and efficient. Though efficiency may undoubtedly require additional special taxes for special purposes it need not require many if policy instruments other than taxation are also being actively directed to this aim.
>
> The potential conflict between the ideals of simplicity and equity, by contrast, is apparently very great indeed. The taxes most obviously adapted to the requirements of equity, those technically capable of being adapted to vary the levy upon individuals in accordance with a multitude of differences in their situations considered relevant to equity, are the most complex of taxes: income taxation, capital gains taxation, gift and estate duties, wealth taxation. Hence it appears that a country may have a simple and efficient taxation system or an equitable one but not both.

[161] Ibid.
[162] Ibid 11-12.
[163] Ibid 20-21.

The conflict between the goals of equity versus efficiency and simplicity was also addressed in the Draft White Paper which stated that measures to make the system more equitable, for example, might require complex legislative provisions and may also cause economic distortions.[164] It was then concluded that 'inevitably, compromises have to be struck among these criteria'.[165] Most recently, the Henry Review Committee stated that in forming tax policy, it is necessary to make judgements about the trade-offs that arise between these fundamental principles in the Australian context.[166]

Can 'Optimal Tax' Theory Resolve the Conflict?

While the Henry Review adopted the same underlying principles in forming tax policy as the previous Australian tax reviews discussed in this chapter, the Henry Review can be distinguished in the approach it took to resolving the efficiency and equity trade-off. In that regard, the Henry Review adopted a modern theory or vision of tax design that has evolved in Australia and in other jurisdictions since the beginning of the 21st Century.[167] Such a theory is usually referred to as 'optimal tax' theory and the literature that considers this theory is concerned 'about the treatment of individuals and how to handle the equity-efficiency trade-off.'[168] In particular, optimal tax theory challenges the general proposition that lower tax rates on a broader tax base are less distortionary.[169] The theory supports the notion

[164] Australian Treasury, *Reform of the Australian Taxation System* (1985) 15.
[165] Ibid.
[166] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 15.
[167] Graeme Cooper, 'Theories of Modern Tax Reformers' (2011) 15(1) *The Tax Specialist* 4.
[168] Ibid 8.
[169] Gregory N Mankiw, Matthew C Weinzierl, and Danny F Yagan, 'Optimal Taxation in Theory and Practice' 2009 23(4) *Journal of Economic Perspectives* 168.

that a complete array of taxes, if carefully constructed, is less distortionary than a single tax.[170] Accordingly, in adopting optimal tax theory, when options for tax reform are being considered, the resolution of the equity-efficiency trade-off may result in a narrower tax base, higher-rate combination achieving the 'optimal tax'.

While there are a number of recommendations in the Henry Review which support the comprehensive tax base approach,[171] there is clearly a shift which is evidenced by the number of recommendations that involve a narrowing of the tax base which stands in stark contrast to the position prior to the Henry Review.[172] Accordingly, the adoption of 'optimal tax' theory in the Henry Review did not change the overarching principles upon which Australia's tax system should be based, however it did change the way in which the trade-off between equity and efficiency is resolved. This modern approach places greater emphasis on the economic and distributional impact of the equity-efficiency trade-offs when determining the optimal tax system.

Where Does Simplicity Fit?

When evaluating the simplicity criteria within Australia's taxation system, the Henry Review highlighted that 'the taxation system and various taxes within the system are more complex today than they have ever been in the past, despite the

[170] Joseph E Stiglitz, 'In Praise of Frank Ramsey's Contribution to the Theory of Taxation' (2015) 125 (583) *The Economic Journal* 236.
[171] See for example, Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009), recommendations 8, 10, 18.
[172] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009)134.

alleged pursuit of simplicity as a fundamental principle in each of the Australian taxation reviews that have occurred'. The Henry Review noted:[173]

> The complexity of the taxation system and the costs of complying with it are perennial concerns, particularly of the business community. Recent research suggests a range of costs associated with this complexity. It reduces transparency, impeding optimal decision making by businesses and individuals and their ability to respond to intended policy signals. It can cause people inadvertently to pay the wrong amount of taxation or claim more or less than they are entitled in transfer payments. It is regressive in its impact, affecting mostly those people with the least capacity to deal with complexity and the least access to professional help.
>
> Significant among the causes of complexity are the pursuit of finely calibrated equity and efficiency outcomes, instability in policy settings and people's incentives to maximise their after-taxation and transfer incomes or after-taxation business profits. The provision of choice in determining a taxation liability can increase complexity and result in higher compliance costs where taxpayers seek to discover the best taxation outcome. Complexity may also be compounded where policy settings within the system do not draw on 'natural' taxpayer systems or are inconsistent with broader policy objectives of government.
>
> Related to the issue of complexity are the costs of administering and complying with the taxation and transfer system. These costs represent a net loss to the economy, because the resources engaged in these activities could otherwise be put to more highly valued uses. Recent research suggests there is an optimal level of system complexity and operating costs, one that balances administration and compliance costs with improved efficiency and distributional outcomes.

As a result of the comments made by the Henry Review above, it is not surprising that in evaluating these trade-offs, the Henry Review was guided by the broad objective that 'policy settings should be coherent and reflect a greater emphasis on simplicity and transparency than is presently evident'.[174] The Henry Review also noted 'the potential opportunities for simplification offered by new digital technology which suggests a considerably larger payoff now than in the past from reassessing the weight given to equity and efficiency relative to simplicity when

[173] Ibid 21.
[174] Ibid 16.

designing policy'.[175] There are a number of recommendations of the Henry Review which are directed or pointed towards a greater focus upon achieving simplicity in the tax system.[176]

Justice Richard Edmonds presented a paper at the 2011 Annual Tax Lecture at the University of Melbourne where he argued that 'architectural' or 'structural' reform to Australia's tax system is necessary, even if this means that the criteria of equity and efficiency are compromised. He stated that if these reforms are not undertaken, then:[177]

> [B]y the middle of this century we will have a tax system so complex that administrators will not be able to properly administer it, taxpayers will not be able to properly comply with it and judges will not be able to properly adjudicate upon it. The stand-alone attributes of equity and efficiency will be so infected with its complexity that, to use the words of the late Ross Parsons, it will be a system which can only be described as an 'institution in decay'. The more cynical among us would say that that time has already arrived. But even if it has not, the time has come when the pendulum has to swing back towards giving preference to simplicity, even if it is at the expense of equity and efficiency. It is the balance that is adopted amongst these aspirational goals which will determine whether the tax system we have in the middle of this century is capable of serving the community and the country in a way which meets the demands that will surely come upon us between now and then.

Accordingly, concerns as to the complexity of Australia's tax system also stem from how the tax law will be properly adjudicated.

The Trade-Off Game and Australia's Next Tax Review?

Australia's program of tax reform since the Asprey Report has been driven by the Government's fiscal adequacy requirements. Once these are met however, the relative weight to be given to the socio-political objectives of equity, efficiency and

[175] Ibid 24.
[176] Ibid i-188. For example, recommendations 2,6,8,9,11,17,36,38,111 and 112.
[177] Hon Justice Richard Edmonds, 'Critique and Comment, A Judicial Perspective on Tax Reform' (2011) 35 *Melbourne University Law Review* 246.

simplicity has largely been determined by the social environment in Australia at any particular time.[178] For example, during the tax reform process that occurred during the period of the Asprey Report and the Draft White Paper, it was efficiency and simplicity that invariably gave way to equity when there was conflict among the fundamental principles. The 1960s were a period in which the emphasis appeared to shift from growth as virtually the only goal for Australian society to one which included 'quality of life' factors such as the welfare of poor and underprivileged minority groups.[179] A study which developed and evolved in parallel to these tax reviews was the Commission of Inquiry into Poverty which in many areas considered the same kinds of factors as covered in these tax reviews. [180] Both the Poverty Inquiry and Asprey Report were concerned with the distribution of economic wealth in Australia.

Since that time however, efficiency and simplicity have driven tax reform over equity where trade-offs have had to be made.[181] The Henry Review's adoption of 'optimal tax' theory may see this trend continue if the economic and distributional approach underlying the decision as to where the balance should be struck favours reform measures that are driven by efficiency considerations. Further, given what was said in the Henry Review in relation to the complexity of the Australian tax

[178] See the discussion regarding tax axiom trade-offs in Tracy Oliver and Scott Bartley, 'Tax system complexity and compliance costs – some theoretical considerations' (2005) *Economic Round up winter 2005*.
[179] See for example the discussion regarding reduction in estate levies against individuals with modest assets in Sam Reinhardt and Lee Steel, 'Brief History' (2006) *Economic Roundup Winter 2006.*
[180] Commission of Inquiry into Poverty, *Poverty in Australia: First Main Report* (1975).
[181] OECD, *Recent Taxation Policy Trends and Reforms in OECD Countries,* No. 9 (2004) 41; see for example the discussion in Chris Evans, 'Editorial: The new Labor government and taxation: Business as usual?' (2008) 37 *Australian Tax Review* 5, 5-6.

system being a 'perennial concern', as well as the deeply entrenched concerns of Justice Richard Edmonds, it is arguable that the tax policy criterion of simplicity is likely to hold greater weight than it has been given previously where trade-offs are to be made between these fundamental principles.

Tax Policy and Corporate Insolvency

Tax policy is aimed at achieving fiscal adequacy as well as the socio-economic objectives of equity, efficiency and simplicity. There are two possibilities that could result in relation to the tax treatment of corporate tax debtors that are insolvent. The first is that insolvent corporate tax debtors are dealt with under the general tax law in the same manner as all other tax debtors. This approach focuses upon the need to achieve fiscal adequacy, efficiency and neutrality in the tax system. The second approach is to make an intentional departure from the general tax law for insolvent corporate tax debtors on the basis that such a departure is necessary in order to influence, in ways desired by the Government, business behaviour, the allocation of resources, and so on.[182] Accordingly, there is no clear answer as to how tax policy should deal with an insolvent corporate tax debtor.

Conclusion

In reviewing each of the major tax reviews that have been undertaken since Federation. It is clear that a theoretical policy-based approach has shaped each of these major reviews. What is also apparent is that there appears to be considerable consistency in these reviews as to the fundamental principles upon which the

[182] Ibid 5.

Australian tax system should be based. The principles of fiscal adequacy, equity, efficiency and simplicity have resonated as the fundamental principles that have shaped each of the major Australian tax reviews and also have international acceptance. In any tax system, trade-offs are often made between the socio-economic principles of equity, efficiency and simplicity and invariably, it has been the social environment in Australia at any particular time which has influenced the relative weight to be given to each principle. With the emergence of 'optimal tax' theory in the Henry Review, it appears that economic and distributional considerations may determine the relative weight to be given to equity and efficiency in future tax reviews. The result is that tax reform measures may take on a new direction, which may involve proposals for reform centered around a less comprehensive tax base, increased tax rates as well as other departures from the traditional tax reform discussion where economic considerations, practical issues and changing conditions make it prudent to do so. Further, the economic analysis driving 'optimal tax' theory must be able to factor into the analysis the impact upon simplicity for the theory to produce a truly optimal taxation.

Chapter 3 will consider the theoretical perspectives of corporate insolvency law. The chapter will also consider whether the theoretical perspectives in tax law find any counterpart in corporate insolvency theory.

Chapter 3 - Theoretical Perspectives of Australian Insolvency Law

Introduction

It has been suggested that insolvency law 'originated from the need to solve the practical commercial problem created by failed business'.[183] In a failing business, if each of the debtor's creditors were to each pursue the individual rights and remedies available to them to recover the amounts they were owed, each would act quickly to protect their own interest which might produce inefficiencies and unfairness.[184] Further, this might be harmful to all of the creditors as a group and to society if the assets could be disposed of together as a going concern for greater value.[185] In the absence of sufficient assets to pay all creditors in full, insolvency law aims to mitigate this 'free-for-all' by establishing a process to ensure 'an efficient and fair collection, realisation and distribution of the debtor's remaining assets'.[186]

A number of international authorities in the field of insolvency law have argued that there are various well defined principles and objectives of insolvency law which are reflected in different national insolvency laws.[187] While there may be

[183] Makham V Lester, *'Victorian Insolvency'* (Oxford, 1995) 37.
[184] Vanessa Finch, *'Corporate Insolvency Law: Perspectives and Principles'* (Cambridge University Press, 2nd ed, 2009) 9.
[185]Rizwaan J Mokal, *'Corporate Insolvency Law: Theory and Application'* (Oxford University Press, 2005) 35.
[186] Vanessa Finch, *'Corporate Insolvency Law: Perspectives and Principles'* (Cambridge University Press, 2nd ed, 2009) 9; Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 63.
[187] Roman Tomasic, 'Insolvency Law Principles and the Draft Bankruptcy Law of the People's Republic of China' (1998) 9 *Australian Journal of Corporate Law* 4. For example, in England, in his text entitled Principles of Corporate Insolvency Law, Professor Roy Goode has identified 10

well defined principles and objectives of insolvency law, there is no established theoretical perspective to turn to for the makeup of principles or aims of insolvency law. Some notable attempts have been made to provide a single or dominant rationale for corporate insolvency law. The two leading insolvency law perspectives include the creditors' bargain theory and communitarianism. These leading theoretical perspectives are distinguished by their differential reliance on the private and public dimensions of insolvency. As neither of these theories addresses tax issues systematically, there is little guidance in the area of tax in insolvency from existing principles or theories.

Australian insolvency law has its roots in British statutes and their common law.[188] In Australia, one of the most influential Australian Law Reform Commission Reports, the Harmer Report which was released in 1988, has significantly influenced legislative agendas, academic writings and government administration in the area of insolvency law.[189] The Harmer Report referred to a number of well established principles of insolvency law. Harmer noted that a fundamental insolvency principle was the need to provide a fair and orderly process for handling the financial affairs of insolvent companies.[190]

principles and 10 objectives of corporate insolvency law. Professor Goode has also listed a number of general objectives of insolvency law administration that have broad recognition. For example, the Cork Report in the UK stressed the importance of having a competent and properly regulated body of insolvency practitioners. However, Fletcher notes that in the UK, the insolvency system is not equipped to prevent abuses occurring.

[188] Christopher F Symes and John Duns, *'Australian Insolvency Law'* (LexisNexis Butterworths Australia, 2nd ed, 2012) 3.

[189] Ibid 5.

[190] Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 288. Nine additional principles were then discussed under the heading of 'Aims of Insolvency Law', Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 15-17.

While the Harmer Report referred to a number of well established principles in insolvency law, the Australian experience is not dissimilar to that of the international experience in relation to providing a single or dominant rationale for corporate insolvency law. In that regard, Australia cannot claim to have developed a theoretical perspective on any aspect of corporate insolvency, including a developed theoretical perspective concerning tax treatment in a corporate insolvency.[191] Theories for corporate insolvency law in Australia are still in their infancy. Since late 2008, the GFC has put insolvency and therefore insolvency law back into focus and further law from both the legislature and common law is now being developed.[192] Accordingly, this may lead to more academic study being directed toward finding a theoretical perspective that has been absent in the past.

This chapter begins by introducing the two most widely accepted perspectives in insolvency law, the creditors' bargain theory and the communitarian perspective. Through examining the possible theoretical and philosophical bases of corporate insolvency law it will be demonstrated that each theory has implications, although at times counterintuitive, for a theory of insolvency tax. In particular, the tax treatment of a corporation in insolvency must have a public law element and so the chapter gives greatest support to the communitarian perspective. The chapter concludes by considering the development of a theory that deals explicitly with corporate insolvency tax.

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[191] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 51.

[192] See for example the *Insolvency Law Reform Bill 2015* (Cth), which has been introduced in order to, amongst other things, harmonise personal and corporate insolvency legislation, reduce costs in insolvency administration and increase regulatory powers.

Theoretical Perspectives of Corporate Insolvency Law – The Private Dimension

Insolvency law is traditionally categorised as a matter of private law as it relates to the private nature of the rights of creditors to receive payment from particular debtors.[193] Insolvency processes also have considerable impact upon private rights in so far as impacting upon pre-insolvency property rights, freezing securities and constraining enforcement processes for individual creditors. It is an area of the law, unlike tax law, which is not as readily linked to the public interest. Such an approach is the basis of one of the leading theories in insolvency law, the creditors' bargain theory which is grounded in law and economics and focuses on individuals as private, autonomous and rational decision makers.[194]

Contractarian Perspective

The dominant perspective in corporate law, the 'nexus of contracts' theory, a theoretical perspective based upon private rights and obligations, lays the foundation for the creditors' bargain theory. The corporation is most commonly regarded as being capable of reduction to a series of contracts, albeit a large number, and this is referred to as a 'nexus of contracts' perspective.[195] The modern nexus of contract perspective was originated in 1937 by Coase, with his theory of

[193] Michael Bridge and Jo Braithwaite, 'Private law and financial crises' (2013) (2) *Journal of Corporate Law Studies* 361, 361 to 362.
[194] Samuel Etukakpan describes the Creditor's Bargain Theory as resulting in a 'collective action' problem when the insolvent corporation is unable to meet its liabilities as 'the individual incentives of each creditor are to act in a way that will be self-beneficial' in Samuel Etukakpan, 'The lost voice in insolvency: theories of insolvency law and their implications for the employees' (2014) 23 *Nottingham Law Journal* 34, 42.
[195] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 51.

'the firm'.[196] He is accredited with first identifying the similarities between corporations and markets. This perspective is consistent with an economic analysis, rather than legal rules and is directed towards 'gaining a better understanding of the economic nature and consequences of law'.[197]

In Australia, Whincop's work is considered to be one of the most significant contributions to law and economics scholarship in corporate law.[198] Whincop explored and tested the nexus of contracts perspective within the construct of the Australian legal system, taking into account the political and economic environment.[199] His research explored the notion of 'the corporation as contract' by turning to the work of Ian Macneil on relational contracts. Relational contract theory can be contrasted to that of classical contract theory which features predominantly in much of the earlier law and economics research.[200] In that regard, relational contract theory is broader in that it goes beyond contracts involving discrete transactions such as simple sale and purchase contracts and recognises that contracts can be more complex, involving long-term relationships between the parties thus involving 'significant elements of non-economic personal

[196] Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 390-391; Robert Flannigan, 'The Economic Structure of the Firm' (1995) 33 *Osgood Hall Law Journal* 115.
[197] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 53.
[198] Michael Whincop, *An Economic and Jurisprudential Genealogy of Corporate Law* (Ashgate Publishing, 2001) 12; Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 53; Peta Spender and Stephen Bottomley, 'How to Do Things with Contractarianism, Michael Whincop's Contribution to Corporate Law Scholarship' (2004) 13(1) *Griffith Law Review* 9-10.
[199] Peta Spender and Stephen Bottomley, 'How to Do Things with Contractarianism, Michael Whincop's Contribution to Corporate Law Scholarship' (2004) 13(1) *Griffith Law Review* 11.
[200] Michel Rosenfeld describes the nineteenth century as the 'classical contract era' in Michel Rosenfeld, 'Contract and justice: The relation between classical contract law and social contract theory' (1984-5) 70 *Iowa Law Review* 769, 820.

satisfaction'.[201] While relational contract theory is broader in the way in which it perceives the idea of a contractual arrangement, it is still essentially 'economic, individualistic and private'.[202]

The Creditors' Bargain Theory

English insolvency authority, Professor Ian Fletcher, has stressed the importance of what he calls 'the principle of collectivity'. Fletcher explains that '[f]oremost among the characteristics of the developed law of insolvency is the principle of collectivity… It is a central tenet of the collectivity principle that the debtor's assets are administered, and creditor claims processed, without any necessary regard to the chronological order in which the assets were acquired or debts created'. [203]

One of the earliest and most recognised attempts to rationalise this principle was the creditors' bargain model which was developed in the US in the early 1980s after a discussion concerning the aims of insolvency law.[204] The creditors' bargain model uses 'law and economics' to explain the collective distribution regime upon liquidation. Thomas Jackson originally developed the model, in collaboration with Douglas Baird and Robert Scott who further developed and refined the creditors' bargain model.[205] The creditors' bargain model has been highly influential to the

[201] Michèle Paulin, Jean Perrien and Ronald Ferguson, 'Relational contract norms and the effectiveness of commercial banking relationships' (1997) 8(5) *International Journal of Industry Service Management* 414, 437.
[202] Michael Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 *Oxford Journal of Legal Studies* 29; Peta Spender and Stephen Bottomley, 'How to Do Things with Contractarianism, Michael Whincop's Contribution to Corporate Law Scholarship' (2004) 13(1) *Griffith Law Review* 14.
[203] Ian F Fletcher, *The Law of Insolvency* (Sweet & Maxwell, 2nd Edition, 1996) 2.
[204] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 34.
[205] Ibid.

development of insolvency law and has been given legislative effect in a number of jurisdictions.[206] More recently, the creditors' bargain model has been criticised on a number of grounds which will be explored later in this chapter. Whilst these commentators consider the creditors' bargain model to be sub-optimal, the model is still considered to be the only 'sustained attempt at a principled analysis of the law governing bankrupt companies'.[207]

Jackson's 'creditors' bargain model' is based upon the idea that there is a notional agreement between creditors, comprising terms that they themselves would consent to before any of them entered into contracts with the company in relation to how the insolvent debtor's estate will be distributed under a collective and compulsory regime, in the event of the company's insolvency.[208] The creditors' bargain model is a member of a family of the contractarian perspective that applies to corporate law because creditors derive their explanatory force from this agreement.[209] The notion of shareholder primacy that underpins the contractarian perspective can be substituted in an insolvent corporation by the concept of creditor primacy, being a requirement to act in the interests of creditors and to maximise their distribution from the debtor's estate.[210]

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[206] For example, the German Bankruptcy Code of 1999 (Insolvenzordnung) is aimed at enhancing the market exchange process and rationalising debt collection rather than overriding market processes.

[207] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 33-34.

[208] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia' (2009) 27(8) *Company and Securities Law Journal* 509.

[209] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 33.

[210] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 56.

This collective procedure is linked to a 'cannon of insolvency law', the *pari passu* principle, which prescribes the equal division of assets of the insolvent estate amongst creditors.[211] The origins of this principle date back to the bankruptcy statute of 1542[212] which was constructed by Chief Justice Coke in the *Case of the Bankrupts* in 1592 where he stated '[s]o that the intent of the makers of the said Act, expressed in plain words, was to relieve the debtors of the bankrupt equally, and that there should be an equal and rateable proportion observed in the distribution of the bankrupt's goods amongst the creditors, having regard to the quantity of their debts...'. [213] The principle of equal distribution is still regarded today as 'the cornerstone of insolvency law', being necessary for the liquidation of insolvent estates in an orderly, efficient and fair manner.[214]

Critiques of the Creditors' Bargain Theory

The notion that insolvency law can find its theoretical framework in the contractarian perspective and through an extension of that perspective, the creditors' bargain model and the law and economics scholarship that underpins it, has been criticised extensively in much of the academic literature. In particular, the

[211] Jason Harris, 'Corporate Group Insolvencies: Charting the Past, Present and Future of Pooling Arrangements' (2007) 15 *Insolvency Law Journal* 78, 83.
[212] The *pari passu* principle was later repeated in the *Bankruptcy Act 1570* (UK).
[213] *The Case of Bankrupts* (*Smith v Mills*) (1589) Trinity Term, 31 Elizabeth I. In the Court of the King's Bench. First Published in the Reports, volume 2, page 25a.
[214] Rizwaan J Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60(3) *Cambridge Law Journal* 582.

most substantial work in the US is presented by Warren[215], Korobkin[216] and Gross[217] while in the United Kingdom (UK), Finch[218], Keay[219] and Mokal[220] push for a more progressive perspective.[221] The criticisms of the creditors' bargain model are discussed below.

Focus on Pre-Insolvency Rights

One of the major criticisms of the creditors' bargain model relates to the circular nature in which the model is framed. In this regard, Finch criticises the creditors' bargain model on the basis that 'it does not make sense to point to a common pool of assets to which creditors have a claim before insolvency'.[222] She argues that 'it is insolvency itself that creates an estate or pool of assets and this undermines any

[215] Elizabeth Warren and Jay L Westbrook, 'The Success Of Chapter 11: A Challenge To The Critics' (2009) *Michigan Law Review* 603; Elizabeth Warren, 'Bankruptcy Policy' (1987) 54(3) *University of Chicago Law Review* 775; Elizabeth Warren, 'Bankruptcy Policymaking in an Imperfect World' (1993) 92(2) *Michigan Law Review* 336; Elizabeth Warren, 'Financial Collapse and Class Status: Who Goes Bankrupt?' (2003) 41 *Osgoode Hall Law Journal* 115; Elizabeth Warren, 'The Untenable Case for Repeal of Chapter 11' (1992) 102(2) *Yale Law Review* 437.

[216] Donald R Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1992) 71 *Texas Law Review* 541; Donald R Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy (1991) 91(4) *Columbia Law Review* 717.

[217] Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University Press, 1997); Karen Gross, 'In Forma Pauperis in Bankruptcy: Reflecting On and Beyond United States v. Kras' (1994) 2 *American Bankruptcy Institute Law Review* 57; Karen Gross, 'Taking Community Interests Into Account In Bankruptcy: An Essay' (1994) 72 *Washington University Law Quarterly* 1031.

[218] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009); Vanessa Finch, 'Control and Co-Ordination in Corporate Rescue' (2005) 25(3) *Legal Studies* 374; Vanessa Finch, 'The Dynamics Of Insolvency Law: Three Models Of Reform' (2009) 3(5) *Law and Financial Markets Review* 438; Vanessa Finch, 'The Measures of Insolvency Law' (1997) 17(2) *Oxford Journal of Legal Studies* 227; Vanessa Finch, 'The Recasting of Insolvency Law' (2005) 68(5) *Modern Law Review* 713.

[219] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 509.

[220] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005); Rizwaan J Mokal., 'On Fairness and Efficiency' (2003) 66(3) *The Modern Law Review* 452; Mokal, Rizwaan J., 'Priority As Pathology: The *Pari Passu* Myth' (2001) 60(3) *Cambridge Law Journal 581*

[221] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 37.

[222] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 35.

assertion that insolvency processes should maximise the value of a pre-existing pool of assets and should not disturb pre-insolvency entitlements'.[223]

Mokal also criticises the creditors' bargain model on this basis and argues that 'if creditors were actually asked ex ante to choose an insolvency regime that they would be unable to reach agreement or would pick a system designed to reflect their pre-insolvency advantages'.[224] Finch highlights that 'creditors differ in their knowledge, their skill, leverage and costs of litigating and that what parties will agree to will inevitably mirror those disparities in right, authority and practical leverage that shape their perspectives'.[225] On this basis, Mokal considers that any agreement made under the circumstances of the creditors' bargain model would likely be 'exploitative and oppressive of weaker parties and would have no justificatory force'.[226] Further, Mokal questions whether this agreement would necessarily be efficient.[227] Mokal's solution to the failings of the creditors' bargain model is to develop an alternative model to analyse and justify insolvency law, which he refers to as the Authentic Consent Model.[228]

Failure to Consider Distributional Consequences

Whilst dealing with creditors in a collectivised manner has considerable, well accepted advantages, criticisms have been made in relation to how the rights under

[223] Ibid.
[224] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 59.
[225] Ibid 36.
[226] Ibid 55.
[227] Ibid; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 36.
[228] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005), Ch 3.

the creditors' bargain model should be determined. In that regard, critics have disputed that the rights of creditors under the regime should be determined by what the parties to the agreement notionally would have agreed to prior to entering into their contracts.[229] Limiting the rights of the parties to a contract to a hypothetical creditor's bargain in this manner, results in the model failing to take into account non-consensual creditors such as creditors that have tort claims and other non-consensual creditors that are impacted as a result of the company's demise including employees, managers, tax authorities and members of the community.[230] Accordingly, the creditors' bargain model is confined to protecting the rights of contract creditors, but fails to protect the rights of these other parties.[231]

Warren argues that by choosing to emphasise the collective action problem of the creditors (primarily the secured creditors), Baird and Jackson 'have adopted a

[229] See the discussion in Shirley Quo, 'Current issues affecting secured creditors: Whether payments to secured creditors can be recovered by liquidators as unfair preferences' (2003) 11 *Insolvency Law Journal* 117, 118.

[230] Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beardbooks, 1986) 25; Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 39; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 35; Douglas Baird and Thomas H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy'(1984) 51 *University of Chicago Law Review* 97. The well-known work of Thomas H Jackson and Douglas Baird explains and justifies bankruptcy without taking community into account; Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) *72 Washington University Law Quarterly* 1031; Michael Bradley and Michael Rosenzweig, 'The Untenable Case for Chapter 11' (1992) 101(5) *Yale Law Journal* 1056 who explain that their economic model is limited to taking into account the interests of stockholders and bondholders under the Bankruptcy Code: 'Effects on stakeholders such as employees, customers, suppliers, and communities are difficult to measure because (unlike stockholders and bondholders) they do not hold claims that trade in organised markets. Similarly, as compared with wealth-maximising stockholders and bondholders, the welfare of some constituents – communities, for example – is less plausibly gauged by reference to quantitative tests. For these reasons, our empirical tests only quantitatively measurable financial claims'.

[231] Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72. *Washington University Law Quarterly* 1032.

covert distributional scheme based on non-bankruptcy rights which she states is overtly distributional in a regressive sense.'[232] Warren refers to a number of comments made by Congress on the US Bankruptcy Code to make a case that a broader set of interests that includes employees and suppliers should be considered in the distribution of an insolvent estate.[233]

Finch also considers this to be a major weakness of the creditors' bargain model. She argues that 'whereas pre-insolvency state entitlements are designed with an eye to ongoing contractual relationships, it is arguably the very purpose of a (federal) insolvency system to apportion the losses of a debtor's default in a new and different situation when a variety of factors impinge on decisions as to where losses should fall.'[234]

Korobkin, another critic of the lack of distributional consequences given by the creditors' bargain model argues that 'in the first instance, that insolvency does and should recognise the interest of parties who lack formal legal rights in the pre-insolvency scenario, not least because parties with formal legal rights never bear the complete costs of a business failure'.[235] Korobkin specifically mentions employees, suppliers, tax authorities and neighbouring traders as parties whose

[232] Elizabeth Warren, 'The Untenable Case for Repeal of Chapter 11' (1992) 102 *Yale Law Review* 473; Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 790, 802, 808; Elizabeth Warren, 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 *Michigan Law Review* 796-97.
[233] Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 775, 778; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 38
[234] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 37.
[235] Ibid 37.

interests need to be considered.[236] If, in fact, it is appropriate to look beyond the pre-insolvency rights of contractual creditors and consider the interests of these non-consensual creditors in determining the distribution of an insolvent estate, this would undermine the very essence upon which the creditors' bargain theory is premised.[237]

Failure to Consider Corporate Rescue

According to the creditors' bargain model, a company that is insolvent should only be rehabilitated if its economic value exceeds the value that could be realised upon immediately selling the business and assets.[238] If the company's ecomonic value is less than this amount, the creditors' bargain model would promote the sale and liquidation of assets, allowing those assets to be utilised in other higher-value enterprise or investment in society.[239]

While Jackson incorporated the idea of reorganisation into his later work with Scott, they held the view that 'bankruptcy proceedings such as Chapter XI … invite dissipation of the common pool by specialists, lawyers, accountants, and economists, who are similarly motivated to secure individual advantage at group expense'.[240] Further, they held the view that reorganisation was not a useful

[236] Donald R Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71(3) *Texas Law Review* 581; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 37.
[237] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 37.
[238] Intan Eow, 'The Door To Reorganisation: Strategic Behaviour or Abuse of Voluntary Administration?' (2006) 30(2) *Melbourne University Law Review* 300; Vanessa Finch, 'The Dynamics of Insolvency Law: Three Models of Reform' (2009) 3(5) *Law and Financial Markets Review* 442.
[239] Ibid.
[240] Thomas H Jackson, 'Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91(5) *Yale Law Journal* 857.

process to implement as it did not ensure that creditors received their pre-bankruptcy entitlements.[241]

The creditors' bargain model has been criticised on the basis that it fails to recognise non-economic values, such as moral, political, social and personal considerations.[242] Generally the insolvency of a company is considered to be a failure of the company in economic terms, resulting from the debtor being unable to pay its creditors.[243] However, it has been recognised that the law of insolvency extends beyond these economic issues and has far broader implications for social issues. For example employees lose jobs, creditors are not paid, traders lose customers and the community is adversely impacted.[244] As Millett J said in Re Barlow Clowes Gilt Managers Limited in relation to the liquidation of companies, '[t]he liquidation of an insolvent company can affect many thousands, even tens of thousands, of innocent people... it can affect people's savings.. In the case of a major trading company it can affect its customers and suppliers and the livelihood of many thousands or persons employed by other companies whose viability is threatened by the collapse of the company in liquidation.'[245]

Further, the economic failure of a business is rarely about the debtor being unable to pay their debts as and when they fall due. Gross has said most poignantly

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[241] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 33; Donald R Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review* 749, 751, 781.
[242] Donald R Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review* 781; Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia Helen Anderson' (2009) 27(8) *Company and Securities Law Journal* 518.
[243] David Morrison, 'When is a company insolvent' (2002) 10 *Insolvency Law Journal* 4, 6.
[244] Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University Press, 1997) 23.
[245] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 527.

'[m]oney is the stand-in for larger failures - failures of particular industries, or failures in the health care system, the commercial and personal lending system, and the educational system. Bankruptcy (meaning corporate and personal insolvency in the UK) addresses the failures within families, such as death or divorce, and the failures caused by nature, such as hurricanes, floods and tornadoes.'[246]

Finch argues that the creditors' bargain model is 'in essence a sale of assets for creditors (what might be termed a 'car-boot sale' image) fails both to treat insolvency as a problem of business failure and to place value on assisting firms to stay in business'.[247] Thus, she considers that resort to non-economic values provides an explanation for laws that might give businesses breathing space for reorganisation, allowing jobs to be preserved.[248] Finch argues that '[u]nlike mere property, a corporation, whether in or out of bankruptcy, has potential. A corporation can continue as an enterprise: as an enterprise, it can change its personality and, perhaps more importantly, whether the corporation continues and how it changes its personality affects people in ways that are not only economic.'[249]

[246] Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University Press, 1997) 23.
[247] Vanessa Finch, 'The Measures of Insolvency Law' (1997) 17(2) *Oxford Journal of Legal Studies* 227, 231.
[248] Ibid 231-232.
[249] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 34-35.

Others, such as Korokbin, take a 'value-based' approach and consider moral, political, personal, social and economic dimensions of corporate failure.[250] This involves consideration of the manner in which the assets of the insolvent company should be distributed in liquidation, as well as the rehabilitation of a company factoring into account the interests of the many stakeholders that would be adversely impacted as a result of the company's failure.[251] Korokbin argues that '[a] corporation, whether in or out of financial distress, is more than [a bankrupt individual]. The law of corporate reorganization developed as a corrective to a bankruptcy jurisprudence that would have ignored a financially distressed corporation's dynamic potential. It reflected a means of bringing the corporation's dynamic personality into public view and regulating not merely its economic division, but the playing out of its moral, political and social values'. [252]

The *Pari Passu* Fallacy

The *pari passu* principle has been criticised on the basis that it 'does not underlie, explain, or justify distinctive features of the collectively regime upon which the creditors' bargain model is founded'.[253] Keay and Walton state that the 'equality' principle is 'nothing more, and has little relevance, other than to act as a convenient

[250] See also Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72(4) *Washington University Law Quarterly* 1031, wherein the author argues the importance of community interests in insolvency.
[251] Donald R Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1991) 91 *Columbia Law Review* 717, 762.
[252] Ibid 745.
[253] Rizwaan J Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60(3) *Cambridge Low Journal* 583, Roman Tomasic, 'Insolvency Law Principles and the Draft Bankruptcy Law of the People's Republic of China' (1998) 9 *Australian Journal of Corporate Law* 7; James O'Donovan, 'Corporate Insolvency: Policies, Perspectives and Reform' (1990) 3(1) *Corporate and Business Law Journal* 11–12.

default principle'.[254] Further, Mokal considers that 'the case-law said to support the *pari passu* principle serves actually to undermine its importance and the principle has nothing to do with fairness in liquidation'.[255]

Fletcher has pointed to the inconsistencies concerning the operation of the *pari passu* principle as a result of the considerable number of exceptions to the principle, including the use of floating charges, the use of trust devices, reservation of title clauses and the doctrine of set-off.[256] Fletcher considers these exceptions to in some instances be 'squarely at odds with commercial and social realities'.[257]

The Australian Perspective on the Creditors' Bargain Theory

Scholars that have considered Australian theoretical perspectives on corporate law have been 'wary of pigeon-holing' their ideas under any perspectives of corporate insolvency law theory, including the creditors' bargain model.[258] The Australian literature focusing upon the theoretical perspectives of corporate insolvency law, discusses its aims and objectives which are considered to be similar to all Western

[254] Rizwaan J Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60(3) *Cambridge Law Journal* 582; See United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice,* Cmnd 8558 (1982), para 1396 noted that rateable distribution among creditors is rarely achieved.
[255] Rizwaan J Mokal, 'Priority as Pathology: The Pari Passu Myth' (2001) 60(3) *Cambridge Law Journal* 583.
[256] Karen Petch also views the doctrine of set-off as a 'significant encroachment on the *pari passu* rule' in Karen Petch, 'Derivatives and the elusive principles of insolvency in Australia: A post-*Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services* analysis' (2012) 30 *Company and Securities Law Journal* 253, 256.
[257] Ian F Fletcher, *The Law of Insolvency* (Sweet & Maxwell, London, 2nd Edition, 1996) 613.
[258] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 62.

legal systems.[259] However, the literature is sparse in relation to supporting the creditors' bargain model or any other perspective.[260]

A number of scholars have considered various provisions within Australia's insolvency laws and through constructing these provisions and considering their judicial interpretation have made assessments as to whether these provisions fit comfortably within the creditors' bargain model. Lightman appeared to regard the 'collective action' objective of the Harmer Committee as explainable in terms of the creditors' bargain.[261]

Routledge looked into two particular areas, the first being the position of secured creditors under voluntary administration, and the second being the focus of achieving the rehabilitation of a company over achieving a greater return to creditors in a liquidation. He concluded that the creditors' bargain model was a useful tool and that the voluntary administration provisions do not appear to be at odds with the creditors' bargain model. His view was that voluntary administration gives creditors an opportunity to make an informed decision that would arguably facilitate a replication of the decision that would be made in an ex-ante creditors' bargain.[262] Anderson also considered the creditors' bargain model in the same

[259] Roman Tomasic, *Australian Corporate Insolvency Law* (Butterworths, 1993) ch 1.
[260] Ibid; Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia Helen Anderson' (2009) 27(8) *Company and Securities Law Journal* 518.
[261] Kylie Lightman, 'Voluntary Administration: The New Wave or the New Waif in Insolvency Law?' (1994) 59(2) *Insolvency Law Journal* 62.
[262] James Routledge, 'Part 5.3A of the Corporations Law (Voluntary Administration): Creditors' Bargain or Creditors' Dilemma' (1998) 6 *Insolvency Law Journal* 130.

context and came to a similar conclusion.[263] These papers however, remain isolated exceptions.[264]

The *pari passu* principle which is linked to the collective procedure underpinning the creditors' bargain theory was endorsed by the Harmer Report.[265] A leading Australian insolvency academic has added that '[t]he principle of equality of division among creditors is fundamental to the whole statutory scheme of winding up and the courts have consistently resisted creditors' attempts to impair it by having specific assets reserved for the payment of specific classes of debts'.[266] Accordingly, the *pari passu* principle is arguably the only principle that has been been given some endorsement in Australia.[267]

[263] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia Helen Anderson' (2009) 27(8) *Company and Securities Law Journal* 518; Also see Peter Linzer, *Uncontracts: Context, Contorts and the Relational Approach, 1988 Annual Survey of American Law* (Princeton University Press, 1988) 139.

[264] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 62.

[265] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 713. 'It is the view of the Commission that, to the maximum extent possible, the principle of equality should be maintained by insolvency subject to two qualifications: it should not intrude unnecessarily upon the law as it otherwise affects property rights and securities and it should encourage the effective administration of insolvent estates. Any departure from this approach should only be countenanced by reference to clearly defined principles or policies which enjoy general community support.'

[266] Roman Tomasic, 'Insolvency Law Principles and the Draft Bankruptcy Law of the People's Republic of China' (1998) 9 *Australian Journal of Corporate Law* 6.

[267] John Martin states that '[o]ne might, from the terms of the Harmer Report and these consequent legislative changes, discern a legislative intent that the priority regime set out in the 1992 legislation was, in effect, a codification of distribution priorities that would apply in a corporate insolvency to the exclusion of any other inconsistent legislation. (The words at the commencement of s 555 would reinforce such an interpretation)' in John Martin, 'Distribution complexities in the winding up of an insurance company in Australia' (2002) 10 *Insolvency Law Journal* 80, 87-88. For an alternate view see *International Air Transport Association v Ansett Australia Holdings* (2008) 234 CLR 151.

The Theoretical Perspectives of Tax Law and Creditors' Bargain Theory

The theoretical perspectives of tax law were considered in Chapter 2. Consideration will now be given to whether the theoretical perspectives of tax law find any counterpart in the creditors' bargain model. As discussed in Chapter 2, this thesis will focus on the principles of fiscal adequacy, equity, efficiency and simplicity in assessing the theoretical perspectives of tax law. The discussion of Australia's tax reviews in Chapter 2 clearly justifies adopting this approach as these are the fundamental principles that have underpinned each of Australia's major tax reviews.

Fiscal Adequacy

The Commissioner will almost certainly feature in insolvency proceedings. In order for the Government to function, it must be able to raise revenue which is undoubtedly a key objective of tax law. The protection of the revenue base is similarly a key objective of tax law.[268]

The creditors' bargain model devotes little attention to tax issues. The only reference to tax issues in the creditors' bargain model occurs in the discussion of statutory liens. Jackson observes that 'the state is itself likely to be a claimant (oftentimes, as in its taxing capacity, a non-consensual one), in which case the level of priority it provides is a part of the cost calculus it has decided on in setting its

[268]Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 3; Australian Treasury, Taxation Review Committee*, Full Report* (1975) 11; Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.

rates (whether tax rates or otherwise).'[269] Accordingly, Jackson suggests that all inconsistencies are resolved through adjustments of tax rates. One commentator argues that this proposition represents the 'extreme conceptual cost of attempting to fit tax policy issues into a contract-based theory of private bargaining'.[270]

Anderson attempts to apply the creditors' bargain model to tax law by considering what the Commissioner would have agreed to accept if they had, in fact, bargained ex ante for their rights.[271] Anderson concludes that the Commissioner 'is a powerful and persuasive advocate in its own cause when demanding rights of recovery in corporate insolvencies. One can therefore presume that the ATO received exactly what it bargained for and what it wanted when the law was amended.'[272] This analysis may be flawed. In that regard, the creditors' bargain model limits the rights of the parties to a contract to a hypothetical creditor's bargain, resulting in the model failing to take into account non-consensual creditors such as the Commissioner.[273] As the Commissioner does not participate in the creditors'

[269] Thomas H Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 *Yale Law Journal* 903

[270] Frances R Hill, 'Toward A Theory Of Bankruptcy Tax: A Statutory Coordination Approach' (1996) 50 *Tax Lawyer* 112

[271] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia' (2009) 27(8) *Company and Securities Law Journal* 2.

[272] Ibid 16.

[273] Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beardbooks, 1986) 25; Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 39; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 35; Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) *72 Washington University Law Quarterly* 1031; Michael Bradley and Michael Rosenzweig, 'The Untenable Case for Chapter 11' (1992) 101(5) *Yale Law Journal* 1056 who explain that their economic model is limited to taking into account the interests of stockholders and bondholders under the Bankruptcy Code: 'Effects on stakeholders such as employees, customers, suppliers, and communities are difficult to measure because (unlike stockholders and bondholders) they do not hold claims that trade in organised markets. Similarly, as compared with wealth-maximising stockholders and bondholders, the welfare of some constituents – communities, for example – is less plausibly gauged by reference to quantitative tests. For these reasons, our empirical tests only quantitatively measurable financial claims'.

bargain, the model would apply so that the tax claims of the Commissioner are not permitted.[274] The theory justifies this outcome on the basis that there is a need to increase the common pool of assets available for distribution to the consensual secured creditors as the secured creditors have bargained to receive this benefit for themselves.[275] Based on the analysis above, if it is accepted that Jackson's suggestion that all inconsistencies are resolved through adjustments of tax rates is flawed and that the creditor's bargain model fails to take into account non-consensual creditors such as the Commissioner[276], then it is clear that there is considerable conflict between the tax policy perspective of fiscal adequacy and the creditors' bargain model. This conflict is further exacerbated as result of fiscal adequacy being the primary objective of tax law.

Equity

The collective process that underpins the creditors' bargain model endeavours to treat creditors equally so that the social effects of the insolvency of a debtor are

[274] Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beardbooks, 1986) 25; Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 39; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 35; Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72 *Washington University Law Quarterly* 1032.

[275] Ibid.

[276] Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beardbooks, 1986) 25; Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005) 39; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 35; Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) *72 Washington University Law Quarterly* 1031; Michael Bradley and Michael Rosenzweig, 'The Untenable Case for Chapter 11' (1992) 101(5) *Yale Law Journal* 1056 who explain that their economic model is limited to taking into account the interests of stockholders and bondholders under the Bankruptcy Code: 'Effects on stakeholders such as employees, customers, suppliers, and communities are difficult to measure because (unlike stockholders and bondholders) they do not hold claims that trade in organised markets. Similarly, as compared with wealth-maximising stockholders and bondholders, the welfare of some constituents – communities, for example – is less plausibly gauged by reference to quantitative tests. For these reasons, our empirical tests only quantitatively measurable financial claims'.

minimised.[277] Such an approach will allow each creditor the possibility of the benefit of distribution from the insolvent estate, rather than allowing a 'a free for all' to take place where those creditors that are stronger and more sophisticated will take all, or at least the majority of, the estate.[278]

As discussed above, connected to the collective procedure is the *pari passu* principle, which has universal recognition and which requires the assets of the insolvent to be equally divided amongst creditors. The *pari passu* principle, however, considers equality amongst consensual secured creditors only and not the broader notion of equality as described in tax law policy which encapsulates 'society' and is customarily distinguished into the two dimensions of 'horizontal' and 'vertical' equity.[279] According to tax law theory, the overall tax burden placed upon the community would be most fairly distributed if all tax levied upon taxpayers could be collected.[280]

The creditors' bargain model puts those parties that do not have formal legal rights pre-insolvency including employees, suppliers, tax authorities, neighbouring traders and the community at a distributional disadvantage. In this way, the creditors' bargain model becomes an agreement among consensual secured creditors that other creditors should receive less in insolvency than they would

[277] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 515.
[278] Ibid.
[279] Australian Treasury, *Reform of the Australian Taxation System* (1985) 14; Australian Treasury, Taxation Review Committee*, Full Report* (1975) 12. 'Horizontal equity – people equally placed should shoulder equal tax burdens. Vertical equity – the more well-to-do should shoulder greater tax burdens than those less fortunately placed. Both of these expressions reflect the 'ability to pay' principle.'
[280] Ibid.

receive if the company was not insolvent. This externalisation of costs forms the basis of Warren's concern as to the creditors' bargain model's alleged lack of honesty on distributional issues.[281] Such externalisation of costs has potentially considerable scope to adversely impact on broader tax law notions of equity.

For example, one hypothesis that has been proposed is that the particular value-shift under the creditors' bargain theory imposes costs on middle class taxpayers and distributes benefits to higher income taxpayers.[282] Accordingly, there appears to be considerable tension between the creditors' bargain model and the tax law policy criterion of equity which arises largely because of the emphasis on private rights in corporate insolvency law versus the public interest element in tax law.

Efficiency

In developing the creditors' bargain model, Jackson and Baird contend that the sole aim of insolvency law is economic efficiency.[283] A collectivised debt regime eliminates the benefit of being the first creditor to make a claim against the debtor, resulting in a reduction in costly and duplicative monitoring of the company's solvency by creditors. Such a regime also avoids the inefficient and wasteful liquidation of a company's assets that would result if individual creditors were to pursue their own rights against the debtor.[284]

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[281] Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 790, 802, 808.

[282] Frances R Hill, 'Toward A Theory of Bankruptcy Tax: A Statutory Coordination Approach' (1996) 50 *Tax Lawyer* 121.

283 Douglas Baird and Thomas H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *University of Chicago Law Review* 97.

[284] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia' (2009) 27(8) *Company and Securities Law Journal* 509, Rizwaan J Mokal, *Corporate Insolvency Law:*

This notion of efficiency that results from the collectivised debt collection regime under the creditors' bargain model is consistent with tax law notions of efficiency which aim to achieve tax law's substantive objective of raising revenue 'at the least possible cost to economic efficiency and with minimal administration and compliance costs'.

Simplicity

The theoretical perspective in tax law of simplicity, does not find any express counterpart under the creditors' bargain model. The Henry Review defined simplicity as '[t]he tax and transfer system should be easy to understand and simple to comply with'. [285] The Harmer Report states that when dealing with claims in insolvency, one of the principles is that the procedure must be 'simple'. [286] In particular, the Harmer Report provides that '[t]o facilitate the proving and administration of claims, the procedure provided should be as simple as possible and the rules relating to various aspects of the procedure (particularly the quantification of claims) should be clear.' [287]

Further, 'simplicity' may be considered a by-product of the creditors bargain theory's focus on efficiency. In this regard, greater efficiencies are achieved as a result of the collective system, for example by avoiding costly and duplicative monitoring of the company's solvency, and it is these efficiencies that make corporate insolvency law easier to understand and simpler to comply with. Through

Theory and Application (Oxford University Press, 2005); Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beardbooks, 1986) 25.

[285] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.

[286] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 315.

[287] Ibid.

this circular reasoning, achieving simplicity can arguably be considered as another area of common ground between the theoretical perspectives of tax law and the creditors' bargain model.

In summary, it is evident that the theoretical perspectives of tax law find little counterpart in the creditors' bargain model. This is particularly the case in relation to the tax law criteria of fiscal adequacy and equity. This conflict is further intensified as a result of fiscal adequacy being the primary objective of tax law. Accordingly, the creditors' bargain model could not provide a rational theory of corporate insolvency tax even if tax issues received more attention. Consideration will now be given to the Communitarian Perspective and whether the theoretical perspectives of tax law find a counterpart in this alternative perspective.

Theoretical Perspectives of Corporate Insolvency Law – The Public Dimension

The second insolvency law theory, communitarianism, rejects a contractarian model of insolvency law. Instead, it suggests a model in which 'we are challenged to act as our brother's and sister's keeper'.[288] Amitai Etzioni, a sociologist and the founder of communitarianism, makes the assertion that 'communitarianism seeks to do for society what environmentalists seek to do for nature, to safeguard and enhance its well-being'.[289]

[288] Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72 *Washington University Law Review* 1040.
[289] Amrtai Etzioni, *The Spirit Of Community: Rights, Responsibilities, and the Communitarian Agenda* (Crown Publishers, 1993) 253-54.

In the mid-1990s a 'radical view' was taken that the corporate insolvency systems should take into account the interests of the community, and that insolvency law should be interpreted from a communitarian perspective.[290] North American, and to a lesser extent British scholars including Keay[291], Finch[292] and Mokal[293], have been pioneers in advocating for a move to a theoretical perspective of insolvency law that goes beyond the creditors' bargain model and recognises the community and importance that the corporation plays within the community, as well as the considerable number of stakeholders that it impacts.[294]

Communitarian Perspective

In contrast with the emphasis on private rights that are central to the creditors' bargain theory, the communitarian counter perspective concerns the broad range of interests of a number of different stakeholders who are impacted by the demise of the company. The list of stakeholders is significant and includes employees, secured and unsecured creditors, customers or clients and the local communities

[290] Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72 *Washington University Law Review* 1031.
[291] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 509.
[292] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009); Vanessa Finch, 'Control and Co-Ordination in Corporate Rescue' (2005) 25(3) *Legal Studies* 374; Vanessa Finch, 'The Dynamics Of Insolvency Law: Three Models Of Reform' (2009) 3(5) *Law and Financial Markets Review* 438; Vanessa Finch, 'The Measures of Insolvency Law' (1997) 17(2) *Oxford Journal of Legal Studies* 227; Vanessa Finch, 'The Recasting of Insolvency Law' (2005) 68(5) *Modern Law Review* 713.
[293] Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005); Rizwaan J Mokal., 'On Fairness and Efficiency' (2003) 66(3) *The Modern Law Review* 452; Mokal, Rizwaan J., 'Priority As Pathology: The *Pari Passu* Myth' (2001) 60(3) *Cambridge Law Journal 581.*
[294] Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72 *Washington University Law Review* 1041.

in which a corporation operates. The communitarian perspective is premised upon the idea that the corporation should respond to each of these stakeholders.[295]

Communitarianism is also distinguishable from contractarianism in relation to the emphasis that it gives to the fair distribution of an insolvent estate. This focus results in creditors who have high priority claims giving way to other claimants, including the community at large, in sharing the value of an insolvent estate.[296] A concern to protect community interest may, for example, favour insolvency laws that require companies and their creditors to bear the costs of financial failure, rather than shift those costs to third parties or taxpayers.[297] This may include environmental clean-up costs or costs involved in tort actions where the company has been found to be negligent.[298]

The recent scholarship concerning the perspectives in corporate insolvency law has supported a perspective that has broader focus. Keay is one leading scholar who has discussed the importance of the public interest. He considers that 'the concept of the public interest, when considered in the corporate insolvency context, has an admirable width'.[299] Keay concludes that, 'rather than formulating a conclusive

[295] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 63, Andrew Keay,' Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 510; Vanessa Finch, 'The Measures of Insolvency Law' (1997) 17(2) *Oxford Journal of Legal Studies* 246.
[296] Elizabeth Warren, 'Bankruptcy policymaking in an imperfect world' (1993) 92(2) *Michigan Law Review* 352-363; Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University Press, 1997); Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 790, 811.
[297]Amrtai Etzioni, *The Spirit Of Community: Rights, Responsibilities, and the Communitarian Agenda* (Crown Publishers, 1993) 253-54.
[298] Elizabeth Warren, 'Bankruptcy Policymaking in an Imperfect World' (1993) 92(2) *Michigan Law Review* (1993) 362-363.
[299] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 533.

definition, the legal system should interpret the public interest as taking into account interests of those parties directly involved in any given insolvency situation'.[300] This is supported by Gross' community approach where she includes many as having a community interest,[301] a term that Keay suggests can equate to public interest.[302] He concludes that in insolvency that '[u]nless the public interest is considered it is likely that rudimentary elements of our society will be damaged and the law will be regarded with contempt as something which is aloof from everyday life'.[303]

Keay divides instances where the public interest is a factor in insolvency law into three broad categories. First, it is in the public interest that insolvencies are resolved in an orderly and expeditious way. Second, it is in the public interest to ensure that commercial morality is enforced, so as to prevent fraud and other improper practices. Third, it is in the public interest that people are protected from the adverse effects which insolvency can produce.[304]

As a result of the current economic climate in recent years, it has become increasingly apparent that the failure of a business can have considerable and far reaching effects on a number of stakeholders within the community. For example, if a company ceases trading, there will be job losses which may require that

[300] Ibid.
[301] Karen Gross, 'Taking Community Interests Into Account In Bankruptcy: An Essay' (1994) 72 *Washington University Law Quarterly* 1031.
[302] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2002) 51(4) *Northern Ireland Legal Quarterly* 509, 524. See also the discussion of Janis Sarra's 'enterprise value maximization theory', a theory which considers the impact of insolvency on non-traditional stakeholders including employees, in Stephanie Ben-Ishai,'Book Reviews: Creditor rights and the public interest: Restructuring insolvent corporations' (2004) 42 *Osgoode Hall Law Journal* 335, 336 to 338.
[303] Ibid 534, 525.
[304] Ibid 510.

workforce to relocate to other areas for secure employment. This reduces the amount of productivity, economic activity and opportunity in that community. The failure of the business will adversely impact upon other community businesses who traded with that business. In addition, if these other community businesses were creditors of that failed business, they may have relied on those debts being paid so that they could pay their creditors. This effect can have significant repercussions, precipitating throughout the community and perhaps beyond.[305]

The recent Senate Economics References Committee Report on Insolvency in the Australian construction industry commented on the far reaching impact of insolvency on on businesses, employees, families and communities.[306] The report commented that:[307]

> The collapse of a business places immediate pressure on the management and employees of that business, as well as its suppliers and contractors. In regional towns, a single insolvency can affect entire communities.
>
> Evidence from witnesses around the country drew attention to the troubling health effects and stresses placed on family life caused by the financial distress stemming from insolvencies. The committee heard evidence of people being affected by mental health issues, family breakdown, people losing their houses and becoming homeless and children facing stress and disruption to their lives...
>
> The economic cost of insolvencies in the construction industry is staggering. In 2013–14 alone, ASIC figures indicate that insolvent businesses in the construction industry had, at the very least, a total shortfall of liabilities over assets accessible by their creditors of $1.625 billion. Others who have analysed the data place the amount at $2.7 billion.

In order to avoid this chain of events occurring, it is often in the public interest that the company be rescued so that it can continue to trade. Such an outcome will

[305] Ibid 518.
[306] Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015) xx.
[307] Ibid.

benefit the employees of the company, businesses that rely on that business for their own enterprise, businesses who have extended credit to the business and will enrich the community at large.[308]

Alternative Approaches

Finch, a pioneer in insolvency law theory, has described her 'visions' which include the forum vision, ethical vision and a multiple values/eclectic approach.[309] Finch has also developed 'a framework' within which 'insolvency law [may] develop with coherence and purpose'. [310] Within this framework, Finch argues that 'legitimacy of the processes and principles of insolvency law can be tested by reference to four values or benchmarks' which include efficiency, equity, accountability and expertise.[311] Finch considers that this limited 'menu of rationales offers a check-list to be dealt with by judges and decision-makers when dealing with insolvency issues who can be invited not to reason with reference to a single or dominant vision of insolvency but to deal with points relevant to each of the four benchmarks'.[312]

[308] Intan Eow, 'The Door To Reorganisation: Strategic Behaviour or Abuse of Voluntary Administration?' (2006) 30(2) *Melbourne University Law Review* 300.
[309] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 43-48.
[310] Ibid; Rizwaan J Mokal, 'On Fairness and Efficiency' (2003) 66 *The Modern Law Review* 453.
[311] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 56.
[312] Vanessa Finch, 'The Measures of Insolvency Law' (1997) 17(2) *Oxford Journal of Legal Studies* 251.

The International Experience

United States

Corporate rescue is allowed in many countries around the world.[313] The US has a long history of fostering a strong tradition of corporate rescue which is at the heart of communitarianism. Chapters X and XI of the *American Bankruptcy Act 1938* (US) was the first piece of legislation to provide a mechanism for reorganisation, including a restructuring of debt and equity, as an alternative solution to liquidation and to insolvency.[314]

According to Warren and Westbrook, 'Chapter 11 of the *Bankruptcy Reform Act of 1978* (Bankruptcy Code) deserves a prominent place in the pantheon of extraordinary laws that have shaped the American economy and society and then echoed throughout the world'.[315] The Bankruptcy Code is based on the idea that a failing business can be reshaped into a successful operation which Warren and Westbrook consider to be to be a 'predictable creation from a people whose majority religion embraces the idea of life from death and whose central myth is the pioneer making a fresh start on the boundless prairie'.[316] The concept of

[313] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia' (2009) 27(8) *Company and Securities Law Journal* 511. See also Rebecca Parry and Haizheng Zhang in 'China's new corporate rescue laws: Perspectives and principles' (2008) 8(1) *Journal of Corporate Law Studies* 113, 113 to 114, in which the authors discuss the common theme of corporate rescue in the decade's global insolvency reforms.
[314] Axel Flessner, *Philosophies of Business Bankruptcy Law: An International Overview in Ziegal J, Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford, 1994) 20.
[315] Elizabeth Warren and Jay L Westbrook, 'The Success Of Chapter 11: A Challenge To The Critics' (2009) 107 *Michigan Law Review* 604.
[316] Ibid.

reorganisation in Chapter 11 has been incredibly influential, influencing commercial law reform throughout the world.[317]

While Chapter 11 has had this profound influence, there has also been a considerable amount of scholarship both in the US and abroad where it has been widely disparaged. Critics argue that the mechanism in Chapter 11 undermines economic efficiency and advocate for its repeal. More recently, some commentators have prompted its repeal as being imminent.[318] Warren and Westbrook have recently challenged these critics by conducting a study which revealed that 'the prospects of Chapter 11 offering a realistic hope for troubled businesses to turn around their operations and rebuild their financial structures are far better than much of the world has been led to believe'.[319]

United Kingdom

The UK also has a long history of fostering a communitarian perspective. In 1982, the influential Cork Report in the UK referred to the law of insolvency as embodying a 'compact to which there are three parties: the debtor, his creditor and society'[320] and stated that English law has always recognised that the community has an interest in insolvency law.[321] This is further supported by the 'aims of a good modern insolvency law' set out by the Cork Committee.[322] Included in the aims

[317] Ibid.
[318] Richard Levin and Alesia Ranney-Marinelli, 'The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005' (2005) 79 *American Bankruptcy Law Journal* 603.
[319] Ibid 640.
[320] United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, para 192.
[321] Ibid para 1734.
[322] Ibid paras 191-8; 203-4; 232; 235; 238-9.

were 'to recognise and safeguard the interests not merely of insolvents and their creditors but of society and other groups in society who are affected by the insolvency, for instance not only the interests of directors, shareholders and employees but also of suppliers, those whose livelihood depends on the enterprise and the community'.[323]

An additional aim of good modern insolvency law set out by the Cork Report which is premised upon the communitarian perspective is 'to preserve viable commercial enterprises capable of contributing usefully to national economic life'.[324] In this regard, the Cork Report stated '[w]e believe that a concern for the livelihood and well-being of those dependent upon an enterprise, which may well be the lifeblood of a whole town or even a region, is a legitimate factor to which a modem law of insolvency must have regard. The chain reaction consequent upon any given failure can potentially be so disastrous to creditors, employees and the community that it must not be overlooked.'[325] In this regard, the Cork Report's statement of aims incorporates aspects of communitarianism. It acknowledges that insolvency affects a number of stakeholders in society and pays particular attention to the importance of insolvency law providing a process in which to rehabilitate viable businesses, being vital to the economic prosperity of a country.[326]

Six years after the production of the Cork Report, Sir Kenneth Cork reflected upon this philosophy in his autobiography, in which he comments:[327]

[323] Ibid para 198 (i) and 203-4, 1375.
[324] Ibid paras 198 and 204.
[325] Ibid para 204.
[326] Ibid para 198 (i) and (j).
[327] Sir Kenneth Cork, *Cork on Cork* (Basingstoke, Hants: Macmillan, 1988) 202-203.

> Through publication of the Cork Report, I have…put forward the principle that business is a national asset and, that being so, all insolvency schemes must be aimed at saving businesses. I have been at pains to stress that when a business becomes insolvent it provides an occasion for a change of ownership from incompetent hands to people who not only have the wherewithal but also hopefully the competence, the imagination and the energy to save the business. Before the 1985 Act every insolvent business went into liquidation or receivership automatically. It was the kiss of death for them and the creator of unemployment…[W]ith the concept of the administrator and voluntary arrangements taking its place in Britain's insolvency law, the chances look bright for more and more businesses being saved in the years that lie ahead…

Insolvency law has increasingly become concerned with the need to offer a distressed business hope of successful corporate rescue post insolvency.[328] In the event that successful corporate rescue results from a proposed rehabilitation of a company, the benefits flow to all of the stakeholders involved in the insolvency proceedings. In that regard, if the debtor is able to avoid the cost of liquidation and turn itself into a viable long-term profitable enterprise, employees will retain their jobs, creditors will be paid more than if the company was liquidated, shareholders will get a greater return on their investment and society will benefit both economically and socially.[329]

In July 2008, the Conservative Party leader, David Cameron, made a speech to the Confederation of British Industry (CBI) Employers' Group outlining proposals to import elements of the US Chapter 11 insolvency system into the UK in order to allow good companies to continue to trade during an economic downturn.[330] The process would be aimed at 'companies which were fundamentally good

[328] J. J. Spigelman, 'Cross-border insolvency: Co-operation or conflict?' (2009) *Australian Law Journal* 44, 52.
[329] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 510.
[330] David Cameron, 'Speech to the CBI' (Speech delivered at the CBI Employer's Group, CBI, 15 July 2008) available at http://conservative-speeches.sayit.mysociety.org/speech/599626 on 12 July 2016; Francis Elliot and Gráinne Gilmore, 'David Cameron Calls for US style Bankruptcy Rules', *The Times* (London, 16 July 2008).

businesses, but whose capital structures no longer allowed them to operate in the current economic climate'.[331] The proposals were based around a 'new fast-track judicial process for distressed companies, as an alternative to administration, based on the best aspects of the American "Chapter 11" system.'[332] Accordingly, with more businesses failing as a result of the economic downturn post GFC, the need to offer a distressed business hope of successful corporate rescue post insolvency has attracted political attention.

The Australian Perspective

The Australian perspective is not dissimilar to that of the US and the UK and readily acknowledges that insolvency law has far broader import than the relationship between debtors and their creditors. The Harmer Report stated, in its opening paragraph, that insolvency law 'concerns not only the principal participants' of debtor and their creditors but it has a direct impact on many others'.[333] The Harmer Report expressly mentions employees, family, customers and agencies of government, such as those concerned with the revenue and administration of the law, as the 'others' upon whom insolvency law has a direct impact.[334] This support

[331] Ibid.
[332] Ibid; Also see Vanessa Finch, 'The Dynamics of Insolvency Law: Three Models of Reform' (2009) 3(5) *Law and Financial Markets Review* 441; Vanessa Finch, 'The Recasting of Insolvency Law' (2005) 68 *Modern Law Review* 713-714 noting that the subsequent amendments to the rescue provisions (pursuant to the *Enterprise Act 2002* (UK)) result in a greater fostering of a culture of rescue. Globalturnaround.com, *British Tories call for 'UK Chapter 11',* July 2008, the Labour Party who held government at the time said the proposals 'would actually create greater risk of companies going under at this difficult economic time because banks would tighten up their business lending ahead of the changes coming into effect'. These proposals were not legislated.
[333] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 3.
[334] Ibid 15.

for the broader approach is consistent with the ideals centred upon communitarianism, and by implication refutes the creditors' bargaining model.[335]

Another goal or principle of insolvency law suggested by the Harmer Report is the effective release of the insolvent entity from financial obligations and liabilities.[336] Another way of looking at this is the facilitation of the financial recovery of the debtor company. This also stresses the value of the North American approach to insolvency of seeking to ensure that the discharged debtor is able to resume business with the least amount of disruption after passing through the insolvency process.[337] The Harmer Report took the view that insolvency law should not be used to achieve regulatory objectives and should instead be compatible with and support the commercial processes of the community.[338]

The voluntary administration procedure in Part 5.3A of the Corporations Act was introduced as a result of the Harmer Report that adopted the English insolvency regime's idea of the possibility of corporate rescue in the Cork Report.[339] Section 435A of the Corporations Act states that the object of Pt 5.3A of the Corporations Act is to maximise the prospects of corporate rescue or, if salvage is not possible, to get a better return for creditors and members than would result from an

[335] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: an Analysis of Preferred Creditor Status* (Ashgate Publishing Limited, 2008) 66.
[336] Roman Tomasic, 'Insolvency Law Principles and the Draft Bankruptcy Law of the People's Republic of China' (1998) 9 *Australian Journal of Corporate Law* 7.
[337] Jennifer Devlin, 'The UNCITRAL Model Law on Cross-Border Insolvency and its impact on maritime creditors' (2010) 21 *Journal of Banking Law and Finance* 95, 105.
[338] Ibid.
[339] David Morrison, 'Deeds of company arrangement and secured creditors' (2015) 23 *Insolvency Law Journal* 181, 182.

immediate winding up of the company.[340] While the design of Pt 5.3A of the Corporations Act has been effective in encouraging distressed businesses to enter into voluntary administration, the results for those businesses that have entered into this form of administration have not been particularly encouraging.[341] Nevertheless, it is useful to keep in mind the Harmer Report's original modest aims in this regard.[342]

The Judiciary has also endorsed aspects of the communitarian perspective with respect to exercising its discretion in taking into account the public interest. Buckley J in *Re Telescriptor Syndicate Ltd*,[343] concluded that the court looks beyond the immediate creditors concerned and '… considers not only whether what is proposed is for the benefit of the creditors, but also whether it is conducive or detrimental to commercial morality and to the interest of the public at large. The mere consent of the creditors is but an element in the case.'[344]

The capacity of the court to exercise its discretion in directing an outcome towards a winding up, when creditors have otherwise shown a preference for some form of compromise or trade out, is further emphasised by Wallwork J in his quotation of the reasons for judgment given by Gillard J in *Re Mascot Home Furnishers Pty Ltd;*

[340] James Routledge and David Morrison, 'Voluntary Administration: Patterns of Corporate Decline' (2009) 27 *Corporate and Securities Law Journal* 95.
[341] Abe Herzberg, Mark Bender and Lee Gordon-Brown, 'Does The Voluntary Administration Scheme Satisfy Its Legislative Objectives? An Exploratory Analysis' (2010) 18 *Insolvency Law Journal* 181.
[342] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 29 commented 'It will be worthwhile and a considerable advantage over present procedures if (voluntary administration) saves or provides better opportunities to salvage even a small percentage of the companies which, under the present procedures, have no alternative but to be wound up.'
[343] [1903] 2 Ch 174.
[344] Ibid 180-181.

Re Spaceline Industries (Aust) Pty Ltd where he expresses '[t]he views of the creditors … were not binding upon the court which was concerned not only with considering whether what was proposed was for the benefit of creditors, but also whether it would be a safe course to sanction, and conducive to commercial morality and in the interests of the public at large.'[345] In *Emanuele v ASC*[346] the Full Federal Court regarded the discretionary powers under sections 445D and 445G of the Corporations Act as needing 'to be exercised having regard both to the interests of creditors as a whole, and in the public interest'.[347]

Theoretical Perspectives of Tax Law and the Communitarian Perspective

We must now consider whether the theoretical perspectives of tax law find any counterpart in the communitarian perspective.

Fiscal Adequacy

The communitarian perspective, which involves consideration of the public interest, directs attention to protecting society from the adverse effects which insolvency can produce. A concern to protect community interests favours the enactment of insolvency laws that require companies and their creditors to bear the costs associated with corporate failure. This includes environmental clean-up costs and any costs associated with the company's negligent actions. This results in the costs of corporate failure remaining with the company and its creditors, rather than those costs being shifted to third parties or taxpayers. Accordingly, this

[345] [1970] VR 593, 596.
[346] (1995) 63 FCR 54.
[347] Ibid 69.

approach is more likely to result in increased collection of tax revenue from an insolvent company than under the creditors' bargain theory.

Further, the focus of the communitarian perspective on distributional consequences recognises the danger of externalising costs to those parties that do not have formal legal rights pre-insolvency including employees, suppliers, tax authorities, neighbouring traders and the community, and seeks an insolvency law system that minimises it. Reducing the externalisation of costs in this manner is also likely to result in increased collection of tax revenue from an insolvent company than under the creditors' bargain theory.

In many cases, consideration of the public interest also directs attention to facilitating the rehabilitation of a financially distressed company. The successful rehabilitation of a business will benefit the Commissioner as the surviving business will pay tax on its taxable income, providing a regular cash flow to government to conduct its spending programs. Further, the company's creditors will either be repaid in full, or partly repaid if it forms part of the plan for rehabilitation. These creditors will also continue to be viable and will pay tax on their taxable income. Shareholders will benefit as they will receive a greater return on their investment and the capital value of their shareholding will be preserved and likely grow. These shareholders will pay income tax on their dividend income and capital gains tax upon the disposal of their shareholdings in that company.[348] Employees of the company will maintain their ongoing employment and pay their income taxes,

[348] ITAA 1936 s44 for the taxation of dividends; ITAA 1997 s 102-5 for the taxation of net capital gains.

further contributing to government revenue.[349] The company's customers derive a benefit as they continue to receive a supply of the company's products and services, paying goods and services taxation on those supplies.[350] These activities act to stimulate the wider economy, which then benefits the wider community. This ultimately results in greater harmony at the intersection of tax law and insolvency law.[351] Accordingly, it can be argued that tax law's fiscal adequacy objective finds its insolvency law counterpart under the communitarian perspective.

Equity

Finch describes fairness as involving giving adequate notice and hearing to interested parties and dealing with issues in an unbiased manner.[352] Mokal makes a distinction between the substantive goals and procedural goals of insolvency law. He considers fairness to be a substantive goal of insolvency law, and efficiency to be a procedural goal of insolvency law and concludes that 'these two "rationales" cannot pull in opposite directions' because substantive goals and procedural ones, ends and means, do not compete'.[353]

The tax law notion of equity encapsulates 'society' and reflects the 'ability to pay' principle.[354] The communitarian focus on distributional issues concerning society, as well as the danger of externalising costs to those parties that do not have formal

[349] ITAA 1997 s6-5. The ordinary income provision.
[350] *A New Tax System (Goods and Services Tax) Act 1999* (Cth).
[351] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 28; James Routledge, 'An Exploratory Empirical Analysis of Pt 5.3A of the Corporations Law, Voluntary Administration' (1998) 16(4) *Corporations and Security Law Journal* 7.
[352] Vanessa Finch, 'Control and Co-Ordination in Corporate Rescue' (2005) 25(3) *Legal Studies* 376.
[353] Rizwaan J Mokal, 'On Fairness and Efficiency' (2003) 66 *The Modern Law Review* 458.
[354] Australian Treasury, Taxation Review Committee*, Full Report* (1975) 12.

legal rights pre-insolvency, lends itself to far broader notions of equity than that of the creditors' bargain model. Communitarians such as Warren contend that 'with an inadequate pie to divide**...** distribution ... is the centre of the bankruptcy scheme', [355] which is what prompts her to call for a clear debate over the distributional consequences of bankruptcy.[356] As discussed, Finch and Korobkin have expressed similar views.[357] Accordingly, this broader notion of equity under the communitarian perspective has far greater alignment with the tax law theory of equity than the creditors' bargain model.

Efficiency

Finch recognises the relevant literature employs several different notions of efficiency including Pareto efficiency and Kaldor-Hicks efficiency, [358] which she rejects, and then employs the notion of transaction cost efficiency or technical efficiency. This notion of efficiency is aimed at achieving desired results (i.e. statutorily mandated results) with minimal use of resources and costs and at minimal wastage of effort.[359] Mokal is critical of Finch's framework and criticises Finch for failing to explain why she simply picks transaction cost efficiency and rejects the other notions of efficiency. While Mokal is critical of Finch, he also

[355] Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 785, 787-788.
[356] Elizabeth Warren, 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 *Michigan Law Review* 796-97; Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 775, 778.
[357] Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009),37; Donald R Korobkin , 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71(3) *Texas Law Review* 581; Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2nd ed, 2009) 37, 38.
[358] Rizwaan J Mokal, 'On Fairness and Efficiency' (2003) 66 *The Modern Law Review* 454-455.
[359] Vanessa Finch, 'Control and Co-Ordination in Corporate Rescue' (2005) 25(3) *Legal Studies* 376; Rizwaan J Mokal, 'On Fairness and Efficiency' (2003) 66 *The Modern Law Review* 453.

adopts the notion of transactions cost efficiency. He states that '[i]t is obvious that to attain transaction cost efficiency should be a (procedural) goal of every part of a morally defensible legal system'.[360]

The communitarian perspective and its focus upon the community does not necessarily result in an outcome that is economically inefficient. Taking into account the interests of the community does not mean that all economic modelling is ignored, rather it calls for a broader economic model.[361] One such model that has been proposed is to expand the economic model to take into account or value things that are not currently considered by the 'narrow economic paradigm'.[362] If such an economic model is adapted to fit comfortably with the communitarian perspective, it can demand that the reorganisation of a company produces the most efficient or highest-valued economic outcome with the resources available.[363] In that regard, rather than economic efficiency being measured narrowly based upon the return to secured creditors under the creditors' bargain model, economic efficiency under this adapted model will be measured upon achieving the optimal economic outcome from the rehabilitation of the company.[364]

The communitarian perspective recognises the value of the debtor's continued existence to society and the external costs of the failure of a business. Business

[360] Rizwaan J Mokal, 'On Fairness and Efficiency' (2003) 66 The *Modern Law Review* 458.
[361] Karen Gross, 'In Forma Pauperis in Bankruptcy: Reflecting On and Beyond United States v. Kras' (1994) 57(2) *American Bankruptcy Institute Law Review* 67-70; Karen Gross, 'Taking Community Interests Into Account In Bankruptcy: An Essay' (1994) 72 *Washington University Law Quarterly* 1031-1035.
[362] Ibid.
[363] Intan Eow, 'The Door To Reorganisation: Strategic Behaviour or Abuse of Voluntary Administration?' (2006) 30(2) *Melbourne University Law Review* 300, 302.
[364] Ibid.

failures produce external costs to employees, creditors, suppliers, shareholders and to the welfare of the wider community. Adopting this expanded economic model involves weighing the benefits to society of a debtor's survival against the costs of its failure.[365] The highest return for creditors may not be the best outcome for the society's overall economic wealth and therefore may not be the most economically efficient outcome under the expanded model.[366] For example, the creditors may want to liquidate the debtor immediately and get their money back while the debtor, if it survives, will continue to supply goods and services to the community that are far more valuable.[367] Accordingly, the overarching reasoning underlying the communitarian perspective is that changes to individual rights are justifiable if the broad range of stakeholders and the community as a whole benefit by preserving the economic value of the company and its resources.[368] As efficiency can be seen to be a legitimate aim under the communitarian perspective, this objective also represents common ground between the theoretical perspectives of tax law and the communitarian perspective.

Simplicity

The theoretical perspective of simplicity in tax law does not find any express counterpart under the communitarian perspective. However, with the focus on community and less emphasis on achieving efficiency goals than under the creditors' bargain theory, it can be argued that the insolvency laws that result are

[365] Ibid 309.
[366] Ibid.
[367] Ibid 308.
[368] Ibid 314.

likely to be more complex under this perspective. In this regard, an American bankruptcy judge, Judge Schermer, argues extra-judicially against the taking into account community interest factors.[369] He argues that the judiciary is faced with three obstacles when making decisions that involve taking into account the community interest, which he refers to as 'definition, application, and the role of the decision maker'.[370] He makes the point that while community interest may be identified, there are so many potential interests in every bankruptcy.[371] He refers to the 'plethora' of potential interests which include minority employment, local jobs, tax revenue and environmental concerns.[372] Further, he argues that community interests cannot be measured which adds another layer of complexity to the decision making process.[373] Ultimately, he concludes that resolving these issues is a broad policy decision for legislators and that the bankruptcy court is not the appropriate forum for defining, applying, and considering community interests.[374]

Another perspective is that while there are concerns raised that by considering the interests of the community, that the communitarian perspective is impractical and therefore not simple, that this same argument can also be made in relation to tax law, which has a public law element. Accordingly, this public interest element present in communitarianism should not adversely impact on achieving simplicity in corporate insolvency tax.

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[369] Barry S Schermer, 'Response to Professor Gross: Taking the Interests of the Community Into Account in Bankruptcy--A Modern-Day Tale of Belling the Cat.' (1994) 72(3) *Washington University Law Quarterly* 1049.
[370] Ibid.
[371] Ibid.
[372] Ibid.
[373] Ibid.
[374] Ibid 1050-1053.

In summary, while the communitarian perspective to corporate insolvency also gives little attention to tax issues in insolvency, its emphasis on inclusion of the community and its obvious attention to distributional issues, have far greater alignment to the theoretical perspectives of tax law than the creditors' bargain model.

The Crossroads of the Theoretical Perspectives of Tax Law and Corporate Insolvency Law

The analysis which has been conducted above supports the emergence of a theoretical perspective of corporate insolvency tax that embraces the perspective that sits at the crossroads of the theoretical perspectives of tax law and the communitarian's perspective of insolvency law.

It has been argued that tax law's fiscal adequacy objective finds its insolvency law counterpart under the communitarian perspective, particularly in relation to the communitarian perspective's focus on distributional outcomes and rehabilitation. Accordingly, fiscal adequacy can be viewed as being at the crossroads of the two theoretical perspectives and thus as an important criteria, albeit not the primary criteria, of any theory of corporate insolvency tax.

The theoretical perspectives of insolvency law are focused on achieving equity goals. The analysis above demonstrates that the definition of equity is much narrower under the creditors' bargain model than under the communitarian perspective. The collective process that underpins the creditors' bargain model endeavours to ensure that creditors are treated equally. This can be contrasted

with the notion of equity under the communitarian perspective which considers the distributional consequences of insolvency and the public interest. This broader conception has far greater alignment with tax law notions of equity which concern the public interest and 'treating individuals with similar economic capacity in the same way'.[375] It is evident that this harmony results from tax law and the communitarian perspective sharing a common public law element. Accordingly, the broader notions of equity as described under the communitarian perspective and tax law can be considered to be at the crossroads of the two perspectives and are an essential criterion of any theory of corporate insolvency tax.

The theoretical perspectives of insolvency law are also focused on achieving efficiency goals. In that regard, the creditors' bargain theory's notion of efficiency is aimed at achieving desired results (to maximise creditors' distribution from the estate) with minimal resources and costs at minimal wastage of effort. Under the communitarian perspective, efficiency is based on a more expansive economic model which takes into account the interests of the community. Each of these notions of efficiency stem from the notion of transaction cost efficiency or technical efficiency which is aimed at achieving desired results with minimal resources and costs at minimal wastage of effort. Transactions costs efficiency is also consistent with tax law notions of efficiency which aim to achieve tax law's substantive objective of raising revenue 'at the least possible cost to economic efficiency and with minimal administration and compliance costs'.[376] Accordingly, efficiency can

[375] Ibid.
[376] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.

be viewed as being at the crossroads of the two theoretical perspectives, and an essential criteria of any theory of corporate insolvency tax.

Simplicity is not an express criterion in any theoretical perspective of insolvency law. There have been concerns raised that by considering the interests of the community, the communitarian perspective is impractical and therefore not simple, however this same argument can also be made in relation to tax law which has a public law element. In this regard, both tax law and the communitarian perspective of corporate insolvency take into account the public interest and are inherently more complex, however that does not prevent simplicity from being a legitimate criterion of a theory of corporate insolvency tax.

In this thesis, Australia's corporate insolvency tax system will be analysed within the framework that has been developed in the preceding chapters. That is, at the crossroads of insolvency law and tax law sits a corporate insolvency tax system which is aimed at achieving fiscal adequacy (and by implication, successful corporate rescue), equity (the broader notion), efficiency and simplicity. Corporate insolvency laws should be aimed at achieving as many of these criteria as possible, and if trade-offs must be made then there must be clear and continuous reference to these theoretical perspectives which will offer a means of assessing current legislative provisions and reform proposals in a manner that is legally coherent, commercially efficient and politically acceptable.

Conclusion

The previous two chapters have examined the theoretical perspectives of tax law and insolvency law which have laid the foundation for a Framework which will be used to assess and evaluate the level of harmony between these areas of law. In particular, this thesis will apply the Framework to a number of select issues in relation to the role of the Commissioner as a creditor in a corporate insolvency. Where considerable disharmony is identified at the intersection of both of these areas of law, recommendations for future law and administrative reform will be made.

A considerable amount of the literature which considers the role of the Commissioner in a corporate insolvency is concerned with whether the Commissioner should be given preferred treatment relative to other creditors. That is, in a corporate insolvency should such claims be paid ahead of other unsecured, and in some cases also secured, claims. Chapter 4 will provide a historical overview of the priority of tax claims in a corporate insolvency in Australia and consider Australia's current position with respect to the priority of tax claims in a corporate insolvency. An evaluation of Australia's current position in relation to tax priorities will be made against the Framework to make an assessment as to the effectiveness of the law.

Chapter 4 - The Role of the Commissioner as a General Unsecured Creditor in a Corporate Insolvency

Introduction

There are a number of stakeholders who play a part in a corporate insolvency, and whose interests need to be accommodated.[377] As tax debts remain outstanding in the majority of corporate insolvencies, the Commissioner is one such stakeholder.[378] The Commissioner's role in a corporate insolvency has become more pronounced as new federal taxes have been introduced and as tax rates have increased, resulting in tax claims representing a greater proportion of the insolvent debtor's estate.[379] This raises questions such as what role should the Commissioner play in times of economic distress? Should the Commissioner be granted tax priority in a corporate insolvency and what form should that priority take? What level of administrative and enforcement powers should the Commissioner have available to enforce the tax law? Should the Commissioner offer assistance to businesses in financial distress, thereby smoothing consumption and absorbing economic shocks? If so, when should this intervention occur and what form should

[377] UNCITRAL, *Legislative Guide on Insolvency Law* (United Nations Publishing, 2005) 9 refers to 'the debtor, the owners and management of the debtor, the creditors who may be secured to varying degrees (including tax authorities and other government creditors), employees, guarantors of debt and suppliers of goods and services. The legal, commercial and social institutions and practices that are relevant to the design of the insolvency law and required for its operation also play an important part.'

[378] Robert Baxt, 'Corporations and securities: The clash between Rules of Corporate Governance and the law' (2014) 88 *Australian Law Journal* 540, 541, citing Finkelstein J in *Timbercorp Securities Ltd (in liq) v WH Chip & Pulp Co Pty Ltd* [2009] FCA 901 [11].

[379] John Duns and John Glover, 'The Taxation Priority in Insolvency: An Australian Perspective' (2005) 14(3) *International Insolvency Review* 171.

it take? These questions must be answered in order to determine the appropriate role of the Commissioner in a corporate insolvency.

The literature which considers the role of the Commissioner in a corporate insolvency is predominantly concerned with two issues. The first issue is whether the Commissioner should be given preferred treatment relative to other creditors.[380] That is, in a corporate insolvency should such claims be paid ahead of other unsecured, and in some cases, also secured claims? The second issue considers the appropriate level of enforcement powers that should be available to the Commissioner in exercising his role in administering the tax law as a creditor in a corporate insolvency.[381]

This chapter is the first substantive chapter in this thesis which evaluates the effectiveness of the role of the Commissioner as a creditor in a corporate insolvency. In particular, this chapter will consider whether the Commissioner should be given preferred treatment relative to other creditors. The chapter will begin by providing a historical overview of the priority of tax claims in a corporate insolvency in Australia beginning with the Imperial Statutes of England and concluding with the Law Reform Commission inquiries that led to the abolition of tax priority. This chapter will then assess Australia's current position against the Framework that was developed in Chapters 2 and 3. That is, if the Commissioner is treated as a general unsecured creditor in a corporate insolvency, what is the impact on fiscal adequacy, corporate rescue, equity, efficiency and simplicity?

[380] See for example David Morrison, 'Never mind the law: Just hurry up and collect more tax! The ATO persists with unnecessary litigation' (2015) 23 *Insolvency Law Journal* 196-208.
[381] See for example David Morrison, 'Why is there a gap in the tax treatment of solvent versus insolvent companies and why does it matter?' (2014) 22 *Insolvency Law Journal* 192, 192-194.

Finally, the chapter will conclude by evaluating the role of the Commissioner as a general unsecured creditor in a corporate insolvency.

Tax Priority in a Corporate Insolvency

Generally speaking, creditors that have a priority in insolvency must be paid first before lower or non-priority debts that are unsecured and paid.[382] This results in the priority creditor receiving a greater distribution of the insolvent estate relative to unsecured and lower priority creditors. Many jurisdictions have legislated so that tax claims are given a priority in a corporate insolvency. There are generally four ways in which a country can prioritise tax debts in insolvency proceedings. These include:

- not giving any priority to pre-insolvency tax claims or to any other kind of pre-insolvency claims;[383]
- not giving any priority to pre-insolvency tax claims but giving priority to other types of claims, such as employee claims;[384]
- giving priority for some pre-insolvency tax claims dependent upon the type of tax, the duration of the tax or a fixed percentage of tax;[385] and

[382] Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 789.
[383] For example, in Austria, Finland and Germany.
[384] For example, in Australia, the UK and Sweden general tax priorities have been abolished, however a priority for some level of employee wage claims still exists.
[385] For example, Canada, New Zealand do not give any special priority for direct income taxes, however special priority is given to taxes collected from third parties that is held on trust by the tax debtor. The US, France Poland, Portugal and Spain limit the duration of the priority period (which can depend on the type of tax involved) or make only a percentage of the tax claims subject to a priority. In Hong Kong and India, tax claims are categorized as either priority or non-priority tax claims based on the period for which the taxes are owed.

- giving priority to all taxes in insolvency proceedings.[386]

The issue of whether tax debts should be given priority in a corporate insolvency has been debated extensively.[387] Law reform commissions and commentators in many jurisdictions have raised a number of policy criticisms for tax claims receiving preferred treatment.[388] Persuaded by these considerations, committees appointed in these jurisdictions to review insolvency laws over the last forty years have recommended uniformly that tax priorities be limited or abolished.[389] Interestingly,

[386] For example, Argentina, Japan, Brazil, and Turkey give some form of tax priority to all types of tax claims.

[387] This debate has spanned decades, evident from the early views of Robert Baxt who wrote priority to the Commissioner could 'swallow up' remaining assets to the detriment of other stakeholders in Robert Baxt, 'Commercial law notes' (1969) 43 *Australian Law Journal* 395, 397.

[388] See the commentary of Ron W Harmer, Commissioner of the Australian Law Reform at the time of writing, in Ron W Harmer, 'Floating Charges: Current Issues (Including Crystallisation and Section 218 of the *Income Tax Assessment Act 1936*)' (1988) 6 *Company and Securities Law Journal* 160, 161, wherein Harmer wrote about the 'damage' priority could cause.

[389] United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice,* Cmnd 8558 (1982) 328-29, recommending abolition of priority for income, corporation, and capital gains tax, but retention of priority for certain quasi-trust debts such as VAT and PAYE, with the period for such preferences reduced; Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 303-04, recommending the abolition of priority for withholding type taxes, noting *'*overwhelming support for total abolition*',* as well as abolishing priority for State, Territory, and local taxes, noting that *'*municipal and local rates and land tax will generally be a charge or otherwise secured over the land and on this basis the specific priority is unnecessary*'*; Canada, Study Committee on Bankruptcy and Insolvency Legislation, *Report of the Study Committee on Bankruptcy and Insolvency Legislation* (1970) 123, *'*In our opinion, the priority of the Crown in our modern society cannot be justified and we recommend that it be abolished*'*; Canada, Advisory Committee on Bankruptcy and Insolvency, *Report of the Advisory Committee on Bankruptcy and Insolvency* (1986) 10-11, *'*The priority of the Crown should be totally abolished under both federal and provincial jurisdiction, and all claims of the Crown should rank in the same priority as unsecured creditors. The elimination of the Crown priority should include all provincial and federal legislation purporting to give priority by way of security, statutory trust or lien or otherwise for any debt not contractually incurred*.'*; United States of America, Commission on the Bankruptcy Laws of the United States, *Report of the Commission on the Bankruptcy Laws of the United States* (1973) 215-16, recommending limiting tax priorities to taxes withheld from wages and one year's taxes for (1) income taxes, (2) ad valorem taxes, (3) employment taxes due on wages paid by debtor, and (4) customs duties and excise taxes, and that statutory tax liens not be recognized in bankruptcy except for liens against property securing a tax of general application based on the value of the property or a special assessment imposed upon the property by any taxing authority if the assessment was imposed for the purpose of defraying the cost of a public improvement.; Germany - Klaus Kamlah,' The New German Insolvency Act: Insolvenzordnung' (1996) 70 *American Bankruptcy Law Journal* 417, 420, In 1985, a Commission formed by the Minister of Justice proposed the abolition of all priority debts.

many of these criticisms have concerned a number of the criteria within the Framework which will be investigated later in this chapter.

The Priority of the Commissioner in a Corporate Insolvency: A Historical Perspective

The Imperial Statutes

In England, the Crown privilege dates from feudal times where the monarch was entitled to an absolute priority for revenue-related debts upon the insolvency of an English subject.[390] The *British Joint Stock Companies Act 1856* and the first *Companies Act* in England in 1862 regulated the order in which payment was made out of the 'assets' of the company.[391] These Acts did not expressly mention the Crown or tax debts as being entitled to any priority in the distribution of the insolvent estate. However, in the 1876 case of *Re Henley & Co*,[392] the Court determined that the Crown was entitled to a priority over all other creditors. As stated by Brett LJ, two Crown prerogatives applied to the Crown's tax claim: 'the first is that the Crown is not bound by a statute in which it is not specially mentioned' and the other is that 'in competition with subjects the right of the Crown must prevail'.[393] At the time, the *Income Tax Act 1842* (UK) expressly

[390] Magna Carta (Confirmed version) 9 Henr. III, 1225, C. 18. The history of the Crown priority in common law countries goes back to the Magna Carta, where it was said that *'*The King's Debtor dying, the King shall be first paid.*'*

[391] *Buchler v Talbot* [2004] UKHL 9, [2004] 2 AC 298; *Re MC Bacon Ltd (No 2)* [1991] Ch 127.

[392] (1878) 9 Ch D 469.

[393] Ibid 482. See also *Re Bonham Ex parte Postmaster General* [1879] 10 Ch D 595; *Re Oriental Bank Corporation* [1884] 28 Ch D 642; *West London Commercial Bank* [1888] 38 Ch D 364; *Exchange Bank of Canada v R* (1886) 11 App Cas 157.

provided for the Crown to 'recover all duties and to distain upon any of the debtor's chattels for the arrears of tax'.[394]

Later, the *Preferential Payments in Bankruptcy Act 1888* (UK) amended the category of 'preferential payments' for rates, taxes and wages to take priority over a floating charge in an insolvent company's assets.[395] The Act provided that:[396]

> [I]n the distribution of the property of a bankrupt, and in the distribution of the assets of any company being wound-up under the Companies Act, 1862, and the Acts amending the same, there shall be paid in priority to all other debts -
>
> > (a) All parochial or other local rates due from the bankrupt or the company at the date of the receiving order, or as the case may be, the commencement of the winding-up, and having become due and payable within twelve months next before that time, and all assessed taxes, land tax, property and income tax assessed on the bankrupt or the company up to the 5th day of April next before the date of the receiving order, or as the case may be, the commencement of the winding-up, and not exceeding in the whole one year's assessment.

Accordingly, the payment of taxes with a cap of one year's assessment was given the highest priority in insolvency proceedings. In *re HJ Webb & Co*,[397] it was held that since the passing of the Act, the authority for Crown priority (*Re Henley*) ceased to be directly applicable. The Crown's right to a priority in corporate insolvencies was subsequently repealed by the *Companies (Consolidation) Act 1908* (UK).

Australian Colonial Laws

Early Australian law on the priority of tax debts largely followed the equivalent English law and made no reference to the Crown.[398] In that regard, whenever there

[394] *Income Tax Act 1842* (UK) s 1.
[395] *Buchler v Talbot* [2004] UKHL 9, [2004] 2 AC 298; *Re MC Bacon Ltd (No 2)* [1991] Ch 127.
[396] *Preferential Payments in Bankruptcy Act* (UK) 1888, s 1.
[397] *Re H J Webb and Co* [1922] 2 Ch 369.
[398] John Duns and John Glover, 'The Taxation Priority in Insolvency: An Australian Perspective' (2005) 14(3), *International Insolvency Review* 171.

was a question of the competing rights of Crown and subject or concurrence of title, the common law gave preference to the Crown.[399] In the absence of legislation providing otherwise, the Crown's rights of execution against the debtor and its property was given priority to recover its claim.[400] The common law prioritised the Crown as a secured creditor unaffected by those priorities prescribed in statute and other competing claims.[401] Accordingly, such a right meant that the Crown was paid ahead of other unsecured creditors.[402]

Post Federation

Post Federation, at around 1930, a number of States drafted new companies legislation and included a priority for tax for the first time. Symes has given three possible reasons for the inclusion of a tax priority including firstly, that the legislative changes followed recent amendments to British companies' legislation, secondly, that the South Australian Parliament and the New South Wales Parliament were guided by the Commonwealth's *Bankruptcy Act 1924* and thirdly, there was a need to secure revenue for the First World War.[403] This priority was maintained in subsequent companies' legislation.[404]

At the Federal level, section 221 of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) provided that income tax priority rank after the costs of winding up and

[399] Law Reform Committee of South Australia, *Proceedings By and Against the Crown*, 104th Report, Report to the Attorney General (1987) 23.
[400] Ibid.
[401] Ibid.
[402] Ibid 24-25.
[403] Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status* (Ashgate Publishing, 2008) 160.
[404] Ibid 162.

employee claims. There was a separate provision which gave a higher priority (although still subject to the costs of winding up) to remittable deductions for Pay as You Earn (PAYE) and withholding tax deductions.[405] Such a high priority meant that, in most insolvent estates, the Commissioner received what was owed or, if not, at least more than any other creditors.[406] The purpose of these provisions, as with the earlier provisions, was stated to be to secure war revenue, this time for the Second World War.[407]

In the early 1960s, the States agreed to attempt greater uniformity of corporate legislation. Section 292 of the *Uniform Companies Act 1961* read:

> 292. (1) subject to the provisions of this Act, in a winding up there shall be paid in priority to all other unsecured debts
>
> ... (e) fifthly, the amount of all municipal or other local rates due from the company at the relevant date and having become due and payable within the twelve months next preceding that date, the amount of all land tax and income tax assessed under any Act or Act of the Commonwealth before the relevant date and not exceeding in the whole one year's assessment...

Accordingly, priority continued to be given to taxes following the enactment of the uniform corporate legislation.

Australian Law Reform Commission Inquiries

In 1978, the Senate Standing Committee on Constitutional and Legal Affairs recommended abolition of all Crown priority.[408] This was contained in a report

[405] Priority remained for unremitted group tax (income tax deducted from salaries or wages of employees) (s221P ITAA 1936), unremitted prescribed payments deductions (s221YHJ ITAA 1936), unremitted natural resource or royalty payment deductions (s 221YHZD ITAA 1936), and unpaid withholding tax (s221YU ITAA 1936).
[406] John Duns and John Glover, 'The Taxation Priority in Insolvency: An Australian Perspective' (2005) 14(3) *International Insolvency Review* 178.
[407] Ibid.
[408] Senate Standing Committee on Constitutional and Legal Affairs, *Priority of Crown Debts,* Parliamentary Paper No. 169 of 1978 (1978).

titled Priority of Crown Debts and known as the Missen Report after the Chair of the Committee, Senator Tony Missen. As a result of the Missen Report, the *Crown Debts (Priority) Act 1981* (Cth) was enacted. The *Crown Debts (Priority) Act 1981* (Cth) merely subjected the Crown in right of the Commonwealth to any State law governing the distribution of insolvent estates. The Act was an adjunct to the States' Companies' Codes to ensure that the Commonwealth Crown was subject to the winding up provisions applying in the States by virtue of their respective Companies Codes.[409] In that regard, the *Companies Act 1981* (Cth), which was the main Commonwealth–State cooperative corporate legislation operating in Australia between 1981–90, provided for tax priority payments. Section 441 of the *Companies Act 1981* (Cth) as originally enacted read as follows:[410]

> Subject to the following provisions of this Subdivision, in the winding up of a company the following debts shall be paid in priority to all other debts: ... (h) ninth –
>
> i. all amounts of rates, being rates that are, or are in the nature of, municipal or other local rates (other than rates imposed by an Act of the Commonwealth or a law of the Australian Capital Territory) that were due and payable at the relevant date and the liability for which accrued within the 12 months that next preceded that date;
>
> ii. all amounts of income tax that were assessed under any Act or Act of any other State or law of a Territory other than the Australian Capital Territory before the relevant date, not exceeding in the whole one year's assessment;
>
> iii. all amounts of land tax that were assessed under any Act or Act of any other State or law of a Territory other than the Australian Capital Territory before the relevant date, not exceeding in the whole one year's assessment;
>
> iv. all amounts of pay-roll tax (other than pay-roll tax imposed by an Act of the Commonwealth) that were due and payable at the relevant date ...

[409] Law Reform Committee of South Australia, *Proceedings By and Against the Crown*, 104th Report, Report to the Attorney General (1987) 23-25.
[410] *Companies Act 1981* (Cth) s 441; Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status, Markets and the Law* (Ashgate Publishing Limited, 2008) 48-49.

This section did not give any priority to the Crown, ranking the Crown ninth in terms of outstanding tax liabilities. Accordingly, it effectively abolished the common law privileges in the context of the winding up of companies. This was the first step to remove tax priority. However, the law retained priorities that related to employers and other persons required to collect and remit taxes.[411]

In 1987–88, the Australian Law Reform Commission conducted an extensive inquiry into insolvency which resulted in the Harmer Report. The Report recommended the tax priority be abolished and set forth a number of arguments in favour of its removal. These included:[412]

- the Commissioner's priority assures the Taxation Department of payment and it consequently is under no pressure to recover it in a normal commercial manner;

- the Commissioner, by allowing taxation debts to accumulate without real risk to the Commissioner's position, may seriously disadvantage the interests of other unsecured creditors;

- taxation debts of insolvents are insignificant in terms of total government receipts but the amount forgone by a private creditor may be the difference between the creditor surviving or failing; and

[411] Priority remained for unremitted group tax (income tax deducted from salaries or wages of employees) (s 221P ITAA 1936), unremitted prescribed payments deductions (s 221YHJ ITAA 1936), unremitted natural resource or royalty payment deductions (s 221YHZD ITAA 1936) and unpaid withholding tax (s 221YU ITAA 1936).
[412] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 300.

- there would be a significant reduction in litigation over the scope of the operation of the Commissioner's priority.

Adding to these arguments was the concern that priority would discourage attempts to rehabilitate companies in financial distress, undermining Australia's Voluntary Administration regime. One of the concerns expressed in the Parliamentary debates at the time of the abolition of the tax priority for unremitted deductions was that Voluntary Administration would be far less attractive to creditors if the Commissioner was able to claim its priority.[413]

Eventually, due to the overwhelming support for the abolition of tax priority which was premised upon 'a strong community view rather than a clear policy preference',[414] the federal Government accepted the recommendation to abolish tax priority in the Harmer Report and Parliament enacted the *Insolvency (Tax Priorities) Legislation Amendment Act 1993* (Cth) in June 1993. However, it should be noted that the abolition of tax priority was not intended to impact upon the revenue.[415] As a compromise for abolishing any priority, a regime for dealing with unremitted group tax deductions was introduced in 1993 which empowered the Commissioner to begin recovery proceedings much sooner than was permitted

[413] Australia, Senate, *Debates*, 19 May 1993, 880 (Senator Robert McMullan); Australia, Senate, *Debates*, 26 May 1993, 1296 (Senator J.O.W. Watson); Australia, House of Representatives, *Debates*, 27 May 1993, 1127 (Mr Rocher MHR –Curtin); Australia, House of Representatives, *Debates*, 27 May 1993, 1136 (Mr Cadman MHR – Mitchell) and Australia, House of Representatives, *Debates*, 27 May 1993, 1132 (Mr Williams MHR – Tangley).
[414] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 302.
[415] Minister for the Arts and Administrative Services, Second Reading Speech to the *Insolvency (Tax Priorities) Legislation Amendment Bill 1993* (Cth). Its stated aim was to 'ensure solvency problems are confronted earlier and the escalation of debts will be prevented.'

previously.[416] Further, the director penalty regime which will be considered in depth in Chapter 7 of this thesis was introduced.[417] In that regard, with tax priority abolished, the role of the Commissioner in administering and enforcing the tax law as a creditor in insolvency was more pronounced.

Australia's Current Position and the Corporate Insolvency Tax Framework

Australia's current position is that all statutory tax priorities have been abolished and therefore no priority is given to tax claims in insolvency. Tax claims are unsecured debts owing to the Commissioner which may be recovered by the Commissioner like any other unsecured claims through the judicial process. This current position can be analysed against the Framework developed in Chapters 2 and 3 of this thesis. That is, if the Commissioner is treated as a general unsecured creditor in a corporate insolvency, what is the impact on fiscal adequacy, corporate rescue, equity, efficiency and simplicity? In order to make this assessment, the current position must be compared to the alternative of re-instating the Commissioner's priority, in some form, against these criteria in the Framework. In making this assessment, the enforcement powers that are available to the Commissioner in exercising his role in administering the tax law as a creditor in a

[416] ITAA 1936, Division 8, s 222ANA(1) provides that '[t]he purpose of this Division is to ensure that a company either meets its obligations under Division 1AAA, 3B, 4 or 8 of this Act or under Sub-div 16B in Sch I to the TAA1953, or goes promptly into voluntary administration under Part 5.3A of the Corporations Act or into liquidation.' See ITAA 1936 ss 222AOB and 222APB.

[417] ITAA 1936, Division 9. As a consequence of the operation of ss 222AOB and 222APB, duties are imposed on directors to cause their company either to comply with payment obligations, enter into a payment agreement, appoint an administrator under Pt 5.3A of the Corporations Act or initiate the winding up process.

corporate insolvency will not be factored into the analysis. This role of the Commissioner will be the subject of further discussion in further chapters.

Fiscal Adequacy

While there are no recent empirical studies that have considered the extent of the loss to the revenue in removing tax priority, in principle, tax priority results in the Commissioner receiving a greater share of the insolvent estate and therefore an increase in tax revenue than if tax debts are treated equally with general unsecured creditor claims. This is because if the tax debts are given priority, they will need to be fully paid before unsecured and lower-priority debts are paid. How much the Commissioner actually recovers will be dependent upon the nature of the priority enjoyed and whether there are assets remaining after secured and higher-priority debts have been paid.

There are a number of strong arguments that support the position that the fiscal adequacy criterion can best be achieved by giving tax debts preferred status. One such argument is that the Government is dependent on Commonwealth revenue to provide public goods, smooth consumption, and absorb economic shocks and that tax priority is therefore required to protect the community interest and to avoid shifting the burden of the debtor's unpaid taxes to other taxpayers.[418] If the Commissioner's powers are constrained in any respect, this can obviously place a considerable burden on the Commonwealth revenue. This view was expressed by Lord MacNaughten in *New South Wales Taxation Commissioners v Palmer*[419] when

[418]Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 300.
[419] [1907] AC 179.

his Lordship stated that the Commissioner's priority 'only means that the interests of individuals are to be postponed to the interest of the community.'[420] Thus, the appropriate amount of debtor default risk resulting from insolvency that the Government is willing to expose itself to, cannot be determined in isolation and needs to be understood in light of the risk-bearing and other roles which the government performs. In particular, to the extent that the Government requires tax revenues in order to sustain its functions, its exposure to insolvency risk should be mitigated.[421] From the Government's perspective, therefore, it is desirable for the Commissioner to have tax priority.

Critics of tax priority argue that tax priority is not needed to protect the community interest, because the Government can reduce its exposure to debtor default risk by establishing tax policy.[422] For example, this can be achieved by broadening tax bases and focusing on tax administration to increase levels of tax compliance in the short to medium-term and setting tax rates in ways that diversify its risks and protect the revenue base without imposing an additional burden on insolvent companies.[423] However, even if the Government were able to manage its exposure

[420] Ibid 182. Also see New Zealand, New Zealand Law Commission, *Priority Debts in the Distribution of Insolvent Estates*, Study Paper 2 (1999) 30*, '*Priority is necessary to protect the revenue. Without priority, the burden of taxation would fall unfairly on solvent taxpayers*.'*; United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, para 8558, *'*it has been represented to us that sums due in respect of unpaid tax ought to have priority, . . . because they are owed to the community'; Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 299, *'*taxation debts are owed to the community rather than an individual*'* and *'*the revenue of the Crown must be protected*'.*

[421] Shu-Yi Oei, 'Taxing Bankrupts' (2014) 55 *Boston College Law Review* 7.

[422] For example, the ATO's Compliance Model is a means by which the ATO is able to better ensure taxpayer compliance. See Robert Whait, 'Developing Risk Management Strategies in Tax Administration: The Evolution of the Australian Tax Office's Compliance Model' (2012) 10(2) *eJournal of Tax Research* 436.

[423] Barbara K Morgan, 'Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy' (2000) 74 *American Bankruptcy Law Journal* 461, 465-69.

to debtor default risk in this manner, the impact of such tax policy changes on revenue and economic growth would need to be carefully assessed to avoid distortionary effects. In that regard, it is well known that changes in tax rates may affect taxpayer behaviour due to labour and substitution effects, which impact upon efficiency and being able to achieve neutrality in the tax system.[424] If the substitution effects of an increase to the tax rate outweigh the income effects, it is possible that there will be a decrease in the supply of labour and a subsequent decrease in the amount of revenues that are collected.[425] Tax rate increases can also impact upon taxable income, tax evasion behaviour and economic growth which would all effect the expected or desired revenue gain in the same manner as a decrease in the labour supply discussed above.[426] For example, abolishing tax priority may lead to a decrease in tax collections due to impacts on taxpayer morale.[427] In this regard, the literature suggests that the perceived level of tax

[424] Karel Mertens and Morten O Ravn, 'Understanding the Aggregate Effects of Anticipated and Unanticipated Tax Policy Shocks' (2011) 14(1) *Review of Economic Dynamics* 27-54; Michael P Keane, 'Labor Supply and Taxes: A Survey' (2011) 49(4) *Journal of Economic Literature* 961-1075.
[425] Ibid.
[426] Raymond Fisman and Shang-Jin Wei, 'Tax Rates and Tax Evasion: Evidence from "Missing Imports" in China', (2004) 112 *Journal of Political Economy* 471; Basil Dalamagas, 'A Dynamic Approach to Tax Evasion' (2011) 39 *Public Finance Review* 309, 310; Cynthia Coleman and Lynne Freeman, 'Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance' (1997) 13 *Australian Tax Forum* 311–336; Benno Torgler and Freidrich Schneider, 'The Impact of Tax Morale and Institutional Quality on the Shadow Economy' (2009) 30 *Journal of Economic Psychology* 228–245; Benno Torgler, 'Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments' (2002) 16 *Journal of Economic Surveys* 657–683; Benno Torgler, *Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis* (Cheltenham: Edward Elgar, 2007); James Alm and Benno Torgler, 'Culture differences and tax morale in the US and in Europe' (2006) 27 *Journal of Economic Psychology* 224–246; James Alm and Benno Torgler, 'Do ethics matter? Tax compliance and morality' (2011) 101 *Journal of Business Ethics* 635–651. Jeff Pope and Margaret A McKerchar, 'Understanding Tax Morale and Its Effect on Individual Taxpayer Compliance' (2011) 5 *British Tax Review Journal* 587–601.
[427] Ibid.

evasion by other taxpayers is one of the factors that can cause taxpayers to be less likely to comply with their tax obligations.[428]

A number of commentators believe that abolishing tax priority will not impact greatly on fiscal adequacy as the tax debt owed to the government in corporate insolvency cases is unlikely to be significant in terms of total government receipts.[429] Further, part of the revenue lost is likely to be recouped as with the abolition of tax priority, private creditors will receive a higher return on their claims and pay additional taxes on those returns.[430]

The 1973 Report of the Commission on the Bankruptcy Laws of the US commented that 'while the Treasury had previously argued against reducing priorities on the grounds that it would experience a substantial revenue reduction, this argument was unfounded'.[431] In contrast, the Commission claimed that the data showed that the revenue loss resulting from reductions in tax priority would be offset 'perhaps to the extent of 50%, by a reduction in the amount of bad debt deductions taken by other creditors.'[432] Similarly, the review committee that produced the Cork Report commented that '[i]t has not been suggested to us that the net loss to the Revenue would be significant if Crown preferences were abolished. A substantial proportion of the tax lost would no doubt be recouped from the increase in

[428] Ibid.
[429] For example, see Barbara K. Morgan, 'Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy' (2000) 74 *American Bankruptcy Law Journal* 467.
[430] Ibid.
[431] United States of America, Commission on the Bankruptcy Laws of the United States, *Report of the Commission on the Bankruptcy Laws of the United States* (1973) 4-484.
[432] Ibid.

dividends payable to ordinary commercial creditors, thereby reducing the amount of bad debts written off by them against trading profits.'[433]

Further, in the case of a successful corporate rescue, the Commissioner will recover more tax revenue than if the company were liquidated.[434] In that regard, the successful rehabilitation of a business will benefit the Commissioner as the surviving business will pay tax on its taxable income, providing a regular cash flow to government to conduct its spending programs. Further, the company's creditors will either be repaid in full, or partly repaid if it forms part of the plan for rehabilitation. These creditors will also continue to be viable and will pay tax on their taxable income. Shareholders will benefit as they will receive a greater return on their investment and the capital value of their shareholding will be preserved and likely grow. These shareholders will pay income tax on their dividend income and capital gains tax upon the disposal of their shareholdings in that company.[435] Employees of the company will maintain their ongoing employment and pay their income taxes, further contributing to government revenue.[436] The company's customers derive a benefit as they continue to receive a supply of the company's products and services, paying goods and services taxation on those supplies.[437] For insolvent corporations that are ultimately liquidated, a loss of priority does not

[433] United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, para 1416.
[434] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 28; James Routledge, 'An Exploratory Empirical Analysis of Pt 5.3A of the Corporations Law, Voluntary Administration' (1998) 16(4) *Corporations and Security Law Journal* 7; Shu-Yi Oei, 'Taxing bankrupts' (2014) 55 *Boston College Law Review* 375, 375-376. 378.
[435] ITAA 1936 s44 for the taxation of dividends; ITAA 1997 s 102-5 for the taxation of net capital gains.
[436] ITAA 1997 s6-5; The ordinary income provision.
[437] *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

prevent the taxing authorities from sharing in an insolvent estate on the same basis as the other general unsecured creditors. In that regard, the government is able to hedge across different types of taxpayers.

In Australia, the Missen Report referred to estimates given by the Commission of Taxation for the 1976-77 financial year which showed that 'while taxation receipts were $15,884 million the amount of taxation debts to which Crown priority could have applied was estimated at $10 million'.[438] The Harmer Report commented that '[t]he net loss to the Commissioner from the abolition of the priority would be insignificant' and that the 'loss of revenue resulting from abolition of the priority would be partially offset by the Commissioner receiving a proportion of the general distribution of the insolvent estate'.[439] While these reports indicate that the loss to the revenue from the abolition of tax priority is not material, these estimates cannot be relied upon as being accurate as they are clearly outdated.

As there is no empirical evidence that considers the loss to the revenue from the removal of tax priority, the only data that can be relied upon and used as a proxy for this empirical evidence are the ATO's annual reports. The ATO reports debt holdings annually and separates its debt holdings into a number of categories which include income tax debt, Superannuation Guarantee Charge (SGC) debt, collectable debt, debt subject to objection or appeal and insolvency debt.

In the 2014-15 financial year, total ATO debt holdings were $35.1 billion.[440] The

[438] Senate Standing Committee on Constitutional and Legal Affairs, *Priority of Crown Debts,* Parliamentary Paper No. 169 of 1978 (1978).
[439] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 300.
[440] FCT, *Annual Report 2014-15* (2015) 44.

total amount of revenue collected by the ATO in the 2014-15 financial year was $336.8 billion in net tax.[441] Accordingly, total debt holdings represented 10.4% of total government revenue for the 2014-15 financial year. Of this total debt, insolvency debt represented $6.3 billion of the $33.3 billion of debt holdings of the ATO,[442] however this figure is misleading as all of the categories of debt holdings could be impacted by some form of insolvency administration. For example, the 2014-15 ATO Annual Report states that the ATO was unable to recover $210 million of existing SGC debt due to employers entering some form of insolvency administration.[443] Whilst the amount of debt holdings attributable to some form of insolvency administration is unclear, these figures demonstrate that government revenue could be materially impacted as a result of the abolition of tax priority. Further, if the trend over the last ten years in the increase of collectable debt continues, this suggests that the loss to the revenue from the abolition of tax priority will be even more significant.[444] Clearly there are limitations in being able to analyse this criterion due to there being no accurate estimates of the loss to the revenue from tax priority's removal. Further, the revenue collected by the Commissioner resulting from insolvency proceedings would need to be determined. Accordingly, in order to be able to comprehensively analyse this criterion, empirical research needs to be conducted to ascertain this information.

[441] Ibid 35.
[442] FCT, *Annual Report 2014-15* (2015) 44. 'Insolvency debt' represents money owed by bankrupts or companies in liquidation.
[443] Ibid 56.
[444] Ibid 11.

Corporate Rescue

A significant driver of insolvency reform across many jurisdictions over the last 20 years has been the development of legislation to both facilitate and promote business reorganisations. [445] This international move from liquidation to reorganisation based insolvency regimes is one of the key drivers in prompting the move to abolish Crown priority in insolvency.[446]

The tension between the creditors, particularly the secured creditors and the Commissioner who are both motivated to protect their rights when a corporation becomes insolvent, are heightened when a corporation is attempting to rehabilitate itself rather than liquidate. Critics of tax priority point to the adverse impacts of priorities on the economic behaviours and interests of private creditors and the corresponding costs to debtors.[447] For example, some commentators have argued that the higher the tax authorities' priority in a reorganisation, the less likely that other stakeholders who are imperative to the success of a proposed reorganisation, such as unsecured creditors and certain secured creditors, will be motivated by the proposal, thereby negatively impacting the possibility of a successful reorganisation.[448]

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[445] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia Helen Anderson' (2009) 27(8) *Company and Securities Law Journal* 511.
[446] Stephanie Ben-Ishai, 'Technically the King Can Do Wrong in Reorganizing Insolvent Corporations: Evidence from Canada' (2004) 13 (2) *International Insolvency Review* 115.
[447] David Morrison comments that priorities create 'stakeholder incentives resulting in perverse behaviour and inconsistent outcomes' in David Morrison, 'Never mind the law: Just hurry up and collect more tax! The ATO persists with unnecessary litigation' (2015) 23 *Insolvency Law Journal* 196, 208.
[448] David R. M. Jackson, 'Forced Collectivization CCRA Style? Creditors Respond to the Latest Source Priority' (2002) 17(1) *National Creditor Debtor Review* 9.

As part of any proposal for reorganisation, the company needs to be able to address the repayment or rescheduling of its liabilities. In order to address these issues and to formulate a plan, the company needs to have a period of time in which it is relieved from paying its creditors.[449] As countries seek to encourage rehabilitation of viable businesses, eliminating the priority for tax claims and treating taxing authorities as general unsecured creditors, who are stayed from enforcing claims upon the commencement of an insolvency proceeding and can be bound by a plan of rehabilitation, is likely to further that objective.[450] Further, while the debt owed to the government may not be significant in terms of total government revenue, the loss to private creditors is likely to have far greater impact by creating substantial hardship to private creditors, resulting in additional insolvencies.[451]

Contrary to these arguments against tax priority, it has been argued that if revenue authorities do not have the security that priority provides, that they will be discouraged from entering into negotiations with the tax debtor to formulate a

[449] Stephanie Ben-Ishai, 'Technically the King Can Do Wrong in Reorganizing Insolvent Corporations: Evidence from Canada' (2004) 13 (2) *International Insolvency Review* 119.
[450] Ibid.
[451] New Zealand, New Zealand Law Commission, *Priority Debts in the Distribution of Insolvent Estates*, Study Paper 2 (1999) 31, *'*The Crown is better able to absorb debt than many traders*';* United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, 320, *'*We unhesitatingly reject the argument that debts owed to the community ought to be paid in priority to debts owed to private creditors. A bad debt owed to the State is likely to be insignificant in terms of total Government receipts; [whereas] loss of a similar sum by a private creditor may cause substantial hardship, and bring further insolvencies in its train.*';* Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 301, *'*Taxation debts of insolvents are insignificant in terms of total government receipts but the amount foregone by a private creditor may be the difference between the creditor surviving or failing.*';* Canada, Advisory Committee on Bankruptcy and Insolvency, *Report of the Advisory Committee on Bankruptcy and Insolvency* (1986) 79, *'*The burden of tax left unpaid by the bankrupt should be divided among all the tax-paying public rather than borne by the creditors, who have already suffered losses.*'*.

payment plan.[452] This can lead to the company being unnecessarily forced into business failure.[453] In that regard, affording priority is beneficial to reorganisation because it encourages revenue authorities to delay their collection activities and work toward a reasonable payment plan with the tax debtor.[454] However, as the International Monetary Fund (IMF) has pointed out, 'while tax priority may encourage the tax collector to delay the collection of taxes from a troubled company and hence facilitate the debtor's rehabilitation, such a failure to collect taxes compromise[s] the uniform enforcement of the tax laws … and, thereby, undermines the disciplinary force that an effective insolvency law is designed to support.'[455] Further, commentators have criticised this argument on the basis that it is overly simplistic to assume that removing priority will make the government work harder to collect tax debts prior to insolvency.[456]

On balance, the arguments against tax priority are stronger in relation to implementing successful corporate rescue post insolvency. This is particularly the case given the comments made by the IMF as well as there being no empirical evidence to suggest that the behaviour of a tax authority towards a taxpayer will change if tax priority is removed. Accordingly, these recent corporate rescue reform efforts support the removal of tax priority.

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[452] Barbara K. Morgan, 'Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy' (2000) 74 *American Bankruptcy Law Journal* 465.
[453] Shu-Yi Oei, 'Who Wins When Uncle Sam Loses? Social Insurance and the Forgiveness of Tax Debts' (2012) 46 *UC Davis Law Review* 430.
[454] Barbara K. Day, 'Better than Nothing: Limiting the Priority for Taxes in Insolvency to Enhance Unsecured Creditor Recoveries' (2006) *International Insolvency Institute* 3.
[455] International Monetary Fund, Legal Department, *Orderly and Effective Insolvency Procedures* (International Monetary Fund, 1999), Privileged Creditors.
[456] Shu-Yi Oei, 'Taxing Bankrupts' (2014) 55 *Boston College Law Review* 51, 54.

Equity

The abolition of tax priority is consistent with notions of equity which are based upon the creditors' bargain theory, and in particular the *pari passu* (equal treatment of claims) principle. The collective process that underpins the creditors' bargain model endeavours to ensure that the social effects of insolvency are minimised as a result of treating creditors equally.[457] This results in each creditor being in a position where they have a chance to get something from a liquidation, rather than letting those creditors who are stronger take most of the assets.[458] However, as discussed in the previous chapter, this notion of equity is based upon equality amongst creditors only and does not consider the broader notion of equity which encapsulates 'society'. Accordingly, this notion of equity is too narrow to operate within the Framework that has been developed and much broader notions of equity are required.

One of the arguments in favour of tax priority which considers this broader concept of equity assesses the distributive consequences of increasing the government's share of debtor default risk against the possibility that as a result of taking on this extra risk, the government may not be able to deliver social insurance to those who have lower socio-economic backgrounds.[459] Similarly, another argument that considers this broader concept of equity is that in order to diversify against this risk,

[457] Michael Quilter, 'The XII Tables as part of bankruptcy's narrative: Identifying creditors' collective rights' (2011) 19 *Insolvency Law Journal* 91.
[458] Andrew Keay, 'Insolvency Law: A Matter of Public Interest?' (2000) 51(4) *Northern Ireland Legal Quarterly* 515.
[459] Elizabeth Warren, 'Financial Collapse and Class Status: Who Goes Bankrupt?' (2003) 41 *Osgoode Hall Law Journal* 115; Teresa A Sullivan, Elizabeth Warren and Jay Lawrence Westbrook, *The Fragile Middle Class: Americans in Debt* (London: Yale University Press, 2000).

the government will raise tax rates, expand the tax base, and use other tools of substantive tax law.[460] Accordingly, removing tax priority does not only have revenue consequences for the government, but it also has distributional consequences for other taxpayers and these consequences of risk diversification must also be considered. The impact to these stakeholders will also be dependent upon the nature of the priority enjoyed by the revenue authority.

Another argument is that the ability of the tax authorities to spread the cost of insolvency default risk to current and future taxpayers through diversification does not mean that risk should be taken and the resulting outcome may be undesirable.[461] Supporters of this argument believe that tax priority is justified for reasons of fairness between taxpayers, and that it is necessary to preserve the integrity and functioning of the tax system.[462] In particular, these distributional consequences resulting from diversification of insolvency default risk represent a tax-shift from secured and priority creditors to current and future taxpayers.[463] This tax-shift represents the reduced tax liability a secured or priority creditor incurs in insolvency compared to the tax liability that same taxpayer would incur outside of insolvency.[464]

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[460] Barbara K Day explains that the government is not at any disadvantage as, unlike private creditors, it has available other means to compensate for tax debts outstanding, including imposition of high interest rates and penalties. See Barbara K Day, '"Better than Nothing": Limiting the Priority for Taxes in Insolvency to Enhance Unsecured Creditor Recoveries' (2006) International Insolvency Institute 3, 4.

[461] Frances R Hill, 'Toward A Theory of Bankruptcy Tax: A Statutory Coordination Approach' (1996) 50 *Tax Lawyer* 121.

[462] Ibid.

[463] Ibid.

[464] Ibid.

Diversifying risk by imposing higher taxes on those taxpayers that comply raises concerns about equity between those who comply and pay their taxes and those who can avoid paying their taxes by declaring insolvency. In that regard, if tax priority is not awarded, this could lead to inequities in tax enforcement whereby compliant taxpayers meet their tax obligations but financially distressed taxpayers can avoid doing so by declaring insolvency.[465] This argument has been made, for example, in the US by the Senate Committee Report to the 1978 *Bankruptcy Reform Act*, which recognised that the US tax system generally works on a voluntary assessment model whose functioning depends on taxpayer perceptions of fairness and that shifting of the burden of raising revenue to compliant taxpayers might be perceived as unfair.[466]

Another example of a tax-shift that occurs from abolishing tax priority is a shift in tax from the debtor's unsecured creditors to the Commissioner. What is particularly important in relation to this tax-shift is the distinction between a claim based on the debtor's personal tax liability versus a claim based on a debtor's obligation to remit funds that have been withheld by the debtor to meet the tax liabilities of third parties, which are essentially held on trust.[467] The most common

[465] US, Senate, *Senate Report No. 95-989* (1978) 95th Cong., 2d Sess.
[466] Ibid.
[467] Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 300 where one of the arguments put in favour of tax priority was that 'it would be contrary to public policy to allow a person authorised to make deductions to use the money deducted to meet ordinary trade debts'; United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, para 1418 notes the involuntary creditor argument is more persuasive for taxes that are 'collected by the debtor, whether by deduction or charge, and for which the debtor is accountable to the Crown; the debtor is to be regarded as a tax collector rather than a taxpayer. Unless some measure of priority were accorded to the Crown for moneys 'collected on its behalf, or they were to be regarded as impressed with a trust, [the moneys] would go to swell the insolvents estate to the advantage of the general body of creditors. We cannot think it right that statutory provisions enacted for the more convenient

example of amounts that a company is obligated to withhold in relation to their employees is tax deducted from wages and salaries and then remitted to the Commissioner.[468] It has been argued that these amounts held on trust should be treated as a special class of tax debts as a failure to prioritise them in this manner will result in the general unsecured creditors receiving a windfall gain at the expense of the Commissioner who will be disenfranchised.[469] As stated by the Commissioner before the Australian Law Reform Commission, 'there is little to be said in favour of tax funds that have been collected by an insolvent debtor being used to swell the funds available to the debtor's private creditors.'[470] This was an argument accepted by the English Cork Committee.[471]

Tax-shifts may also result from increasing taxes on labour or on future generations in order to diversify against revenue losses from corporate insolvencies. However, simply identifying tax-shifts is not in itself a sufficient reason to argue in favour of tax priority. In all cases involving tax-shifts, there is likely to be distributive, equitable, and efficiency consequences as a result of the increased tax burden on

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collection of the revenue should enure to the benefit of private creditors'; New Zealand, New Zealand Law Commission, *Priority Debts in the Distribution of Insolvent Estates*, Study Paper 2 (1999) 31 which states that these debts 'represent monies payable by the debtor to the Commissioner on behalf of another person. Thus, it is argued that there is an analogy with the law of trusts so that the debts should be afforded priority even though the monies may have been mingled with other fungibles, and are therefore no longer traceable.'

[468] Ibid.

[469] Ibid. This argument is even more persuasive under the PAYE regime in New Zealand where the the Commissioner retains the right to claim unpaid PAYE from the employee as well as the employer under s 168(2) *Tax Administration Act 1994* (NZ), resulting in a tax shift from from the debtor's unsecured creditors to the tax debtor's employees.

[470] This was a point made by Vinelott J in Re Stanford Services Ltd (1987) 3 BCC 326 at 334, quoted in the Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) at para 737; Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 299-303, the FCT described the Commissioner's right to payment of these amounts as being equivalent to a trader's right to reclaim goods under a retention of title clause.

[471] United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, paras 1409-50.

the taxpayers who have been the object of the tax-shift that need to be carefully considered.[472] In that regard, the impacts of tax priority removal will be regressive if it imposes a cost on middle class taxpayers and distributes benefits to higher income taxpayers. However, such impact would be considered to be progressive if the value-shift was in the alternative. It appears as though a tax shift from the debtor's unsecured creditors to the debtor's employees may be an example of a regressive tax which would be undesirable, however there is no empirical evidence to support this hypothesis. Similarly, the examples given above of possible tax shifts may also be regressive in nature, however as there is no empirical research that has considered the impact of removing tax priority on this broader notion of equity, a definitive conclusion cannot be reached. Accordingly, such data is imperative to be able to comprehensively assess this criterion within the Framework and to ensure that any tax shifts that are made as a result of the removal of tax priority do not adversely impact on the equity criterion.

Efficiency

When regard is given to efficiency within the Framework, two issues must be considered. Firstly, whether tax priority increases or reduces the efficiency of insolvency proceedings, and secondly, whether tax priority allows the Commissioner to raise revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs.

[472] Shu-Yi Oei, 'Taxing Bankrupts' (2014) 55 *Boston College Law Review* 7, 49.

In relation to the efficiency of the insolvency proceedings, the efficiency underpinnings of removing tax priority reflect the influence of creditors' bargain theory and the 'collective' regime.[473] In that regard, Jackson and Baird's contention is that the sole aim of insolvency law is economic efficiency.[474] The collectivised debt regime has the advantage of avoiding the costly and duplicative monitoring of the company's assets that would result if each creditor were to make an individual claim. It also eliminates inefficiencies that would result from the liquidation of a company's assets by individual creditors which makes the administration at the time of liquidation more efficient.[475]

Further, arguably the communitarian perspective supports the removal of tax priority where efficiency is concerned if the result is the survival of a viable business. This perspective emphasises the value of a debtor's survival to society. It also recognises the external costs of business failures such as the loss of jobs, the impacts on suppliers and the broader community.[476] The approach to be taken under this perspective is to weigh the benefits to society of a debtor's survival against the costs of its failure.[477] Once this assessment is undertaken, one possibility may be that the highest return for creditors may not be the best outcome for the society's overall economic wealth. If this is the case, it will be in

[473] Douglas Baird and Thomas H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *University of Chicago Law Review* 97; Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 800-8-4.
[474] Ibid.
[475] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia' (2009) 27(8) *Company and Securities Law Journal* 509, Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005); Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beardbooks, 1986) 25.
[476] Intan Eow, 'The Door To Reorganisation: Strategic Behaviour or Abuse of Voluntary Administration?' (2006) 30(2) *Melbourne University Law Review* 300.
[477] Ibid.

the creditor's best interests for the debtor to be liquidated so that they can get their money back. However, that would not produce the most economically efficient outcome for society. In that regard, if the debtor successfully rehabilitates, it can continue supplying goods and services to the community that are far more valuable, thereby maximising the economic value of the company and its resources and continue to pay its outstanding and future tax liabilities.[478]

Further, studies commissioned in various countries have also taken the view that support for tax priority cannot be justified upon efficiency grounds. Commissions in England, Australia, Canada, Germany, and New Zealand have all recommended limiting or abolishing priority for tax debts, with one of the significant factors in making these recommendations being that priority reduces the efficiency of insolvency proceedings. [479] In addition, in the last two decades, various international organisations have argued that tax priority is unjustified, largely on efficiency grounds. For example, the United Nations Commission on International Trade Law (UNCITRAL) has recommended that all unsecured creditor priorities, including tax priority, should be minimised because 'they can complicate the basic goals of insolvency and make it more difficult to achieve efficient and effective

[478] Ibid 308, 314.

[479] United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice,* Cmnd 8558 (1982) 328-29, 303-04; Canada, Study Committee on Bankruptcy and Insolvency Legislation, *Report of the Study Committee on Bankruptcy and Insolvency Legislation* (1970) 123; Canada, Advisory Committee on Bankruptcy and Insolvency, *Report of the Advisory Committee on Bankruptcy and Insolvency* (1986) 10-11; United States of America, Commission on the Bankruptcy Laws of the United States, *Report of the Commission on the Bankruptcy Laws of the United States* (1973) 215-16; Germany - Klaus Kamlah, 'The New German Insolvency Act: Insolvenzordnung' (1996) 70 *American Bankruptcy Law Journal* 417, 420.

insolvency proceedings'.[480] Similarly, the IMF has taken the position that 'even though secured creditors should have priority based on their ex ante negotiated rights, any other priorities are inequitable to unsecured creditors and may undermine the efficiency and overall effectiveness of the proceeding by causing complexity and creditor disengagement'.[481] Accordingly, where the efficiency of insolvency proceedings are being assessed, the abolition of tax priority must be the preferred position.

The second measure of efficiency is concerned with whether the tax system will be more efficient with or without tax priority. Importantly, to be efficient, the tax system should not influence individual and business choices, that is, it should be neutral.[482] Inefficiency in this regard is represented by the extent that tax affects people and businesses' choices, incentives to work, save, invest or consume things of value to them.[483] The size of these efficiency costs varies from tax to tax and the extent of these distortions can be compared to the amount of revenue being raised from that tax in order to determine whether the tax is efficient.[484]

The literature that considers the efficiency of tax priority in this context argues that tax priority is likely to distort normal commercial incentives. For example, the World Bank has developed guidelines that provide that security interests in collateral should be respected and that distributions after that should be made *pari*

[480] UNCITRAL, *Legislative Guide on Insolvency Law* (United Nations, 2005) 346.
[481] International Monetary Fund, Legal Department, *Orderly and Effective Insolvency Procedures* (International Monetary Fund, 1999), Privileged Creditors.
[482]Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 5-6; Australian Treasury, Taxation Review Committee*, Full Report* (1975)16.
[483] KPMG Econtech, *CGE Analysis of the Current Australian Tax System*, Final Report (2010) 17.
[484] Ibid.

passu among unsecured creditors.[485] Within these guidelines, it noted that '[l]egislators should resist the temptation to create a proliferation of priority classes based on special interests rather than solidly endorsed and widely embraced social policies', also noting that '[w]hile many such policies recognize important public interests, such as preserving the state's revenue base…, these broader public interests compete with private interests and may distort normal commercial incentives'.[486]

Further, commentators argue that removing tax priority will be more efficient in the sense of minimising distortive borrowing and lending behaviours and minimising distortionary behaviours by creditors on the eve of insolvency that will ultimately reduce the value of the insolvent estate.[487] The extent of these distortions can then be compared to the amount of revenue being raised. If a company is insolvent, then how much the Commissioner actually collects will depend on whether there are assets remaining after secured and higher-priority debts have been paid. As discussed in relation to the analysis of the fiscal adequacy criterion, the revenue gain from tax priority is uncertain. However, based on the considerable distortionary effects of tax priority, in order to be efficient, the revenue raised from tax priority must be significant. For example, if empirical research is conducted which confirms the Harmer Report's suggestion that the

[485] World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (2001) 9 (Principle 16), 146.
[486] Ibid at 148.
[487] Shu-Yi Oei, 'Taxing Bankrupts' (2014) 55 *Boston College Law Review* 25, 30.

amount of revenue raised from tax priority is 'insignificant',[488] then there is a strong case that tax priority is inefficient.

If tax priority is removed and there is a significant reduction in revenue, the government may have to diversify against the risk of insolvency by increasing tax rates. Effectively, to achieve this, there will be a tax shift from one tax to another. Any distortionary effects from the tax shift must be assessed and measured in order to be able to determine tax efficiency. These economic issues have been touched upon in assessing the fiscal adequacy criterion. As discussed, under certain circumstances, tax rate increases may yield changes in taxable income, labour supply, tax evasion behaviour, and economic growth that may compromise desired revenue gains.[489] Clearly, these distortionary effects must be avoided in order for the removal of priority to be efficient. In that regard, distortionary effects are likely to be reduced if the tax shift is made by increasing the least distortionary taxes. These taxes include consumption taxes, recurrent property taxes and environmental taxes.[490]

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[488] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 301.
[489] Raymond Fisman and Shang-Jin Wei, 'Tax Rates and Tax Evasion: Evidence from "Missing Imports" in China' (2004) 112 *Journal of Political Economy* 471; Basil Dalamagas, 'A Dynamic Approach to Tax Evasion' (2011) 39 *Public Finance Review* 309, 310. Cynthia Coleman and Lynne Freeman, 'Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance' (1997) 13 *Australian Tax Forum* 311–336; Benno Torgler and Freidrich Schneider, 'The Impact of Tax Morale and Institutional Quality on the Shadow Economy' (2009) 30 *Journal of Economic Psychology* 228–245; Benno Torgler, 'Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments' (2002) 16 *Journal of Economic Surveys* 657–683; Benno Torgler, *Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis* (Cheltenham: Edward Elgar, 2007); James Alm and Benno Torgler, 'Culture differences and tax morale in the United States and in Europe' (2006) 27 *Journal of Economic Psychology* 224–246; James Alm and Benno Torgler, 'Do Ethics Matter? Tax Compliance and Morality' (2011) 101 *Journal of Business Ethics* 635–651; Jeff Pope and Margaret A McKerchar, 'Understanding Tax Morale and Its Effect on Individual Taxpayer Compliance' (2011) 5 *British Tax Review Journal* 587–601.
[490] Johansson, Asa, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, *Tax and Economic Growth*, OECD Economics Department Working Papers (2008). The indications from this analysis are

For example, studies conducted by the European Commission have shown that a revenue-neutral shift from labour to environmental taxes would increase consumer welfare (particularly by reducing greenhouse gas emissions) and favour job creation.[491] Accordingly, such a tax shift would be considered to have minimal distortionary effects and therefore be efficient. Similarly, while there have been no studies conducted in relation to revenue neutral shifts from the abolition of corporate insolvency tax priority, it may be the case that a revenue neutral shift from corporate insolvency tax priority to a less distortionary property tax could have the effect of achieving increased vertical equity (as progressive property taxes are effectively a tax on wealth) and favour the reorganisation of viable businesses.[492] If this tax shift were to occur, it would have minimal distortionary effects and be considered efficient.

Against the strong efficiency arguments in favour of removing tax priority is concern that insolvency might be too effective a way for secured and priority creditors to free ride if tax debts are not protected with preferential status.[493] In

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that property taxes have the least detrimental impact on growth, followed in order by taxes on consumption, taxes on labour income and taxes on capital income. The OECD analysis only looks at the issue of the tax mix from the perspective of economic efficiency. Also see European Commission, *Tax reforms in EU Member States Tax policy challenges for economic growth and fiscal sustainability,* Taxation Papers: Working Paper N.34/2012, 2012 Report (2012).

[491] European Commission, *Tax reforms in EU Member States Tax policy challenges for economic growth and fiscal sustainability,* Taxation Papers: Working Paper N.34/2012, 2012 Report (2012) 32. In its recent Working Paper concerning tax policy challenges for economic growth and fiscal sustainability, the EU established screening principles when identifying a potential need, and room, for a tax shift. The tax shift in that context concerned a shift from taxes on labour to taxes on less distortionary taxes. In particular, the EU identified that it was necessary to make an assessment as to whether there is scope for increasing those less distortionary taxes which involves considering whether the share of revenues from that tax are significantly below average (the EU average in that context). If so, there is considered to be scope for the tax shift.

[492] Ibid.

[493] Avinash Dixit and John Londregan, 'Redistributive Politics and Economic Efficiency' (1995) 89(4) *American Political Science Review* 856.

that regard, the benefits of abolishing tax priority go to a small proportion of the population, in this case secured and priority creditors, with a large individual interest in the insolvent estate.[494] The taxes that finance the benefits of the abolition of tax priority fall on the general population with a very small impact upon each individual.[495] The general population is in the position where they are unlikely to notice the cost amongst all of the other tax expenditures of government, or they do not see the value in opposing these policies, which results in those secured and priority creditors being able to 'free ride' once the corporate tax debtor enters into external administration.[496]

While it is possible that by removing tax priority some inefficiency may be created due to the 'free-rider' problem, the efficiency arguments favouring the removal of tax priority (forming the basis of the two theoretical perspectives of insolvency law) and recommendations made by the country-specific study commissions and the international organisations which have resounding international acceptance, cannot be overlooked. Further, if the removal of tax priority does have adverse revenue implications which requires a tax shift to create revenue neutrality, the tax will be more efficient provided that any tax shift is less distortionary than imposing tax priority. The studies above indicate that such a tax shift could be achievable. Accordingly, there is a strong argument on efficiency grounds for the abolition of tax priority.

[494] Ibid.
[495] Ibid.
[496] Ibid.

Simplicity

When regard is given to simplicity within the Framework, consideration must be given to whether the tax system is simpler with or without tax priority. Many of the arguments in favour of the abolition of tax priority discussed under the efficiency criterion are also applicable in relation to achieving simplicity within the Framework. In that regard, in relation to the insolvency proceedings, the 'collective' regime that results by removing tax priority makes the system simpler to administer as it has the advantage of avoiding the costly and duplicative monitoring of the company's assets that would result if each creditor were to make an individual claim.[497] It also eliminates inefficiencies that would result from the liquidation of a company's assets by individual creditors which makes the administration at the time of liquidation simpler.[498] The more creditors that have priority, the greater complexity in determining the scope of the priority and quantifying the claims of that priority creditor.[499]

This simplicity criterion was one factor that the Harmer Report considered in recommending the removal of tax priority. In that regard, the Harmer Report commented 'there would be a significant reduction in litigation over the scope of the operation of the Commissioner's priority and that there had been a multitude of cases (both reported and unreported) on this priority and many of the reported

[497] Helen Anderson, 'Theory and Reality in Insolvency Law: Some Contradictions in Australia' (2009) 27(8) *Company and Securities Law Journal* 509, Rizwaan J Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press, 2005); Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Beardbooks, 1986) 25.
[498] Ibid.
[499] Ibid.

cases contain judicial pleas for s 221P (the Commissioner's tax priority power) to be clarified'.[500]

Accordingly, if the impact to the revenue from the abolition of priority is insignificant, the insolvency procedure and the tax system would be easier to understand and simpler to comply with if tax priority was removed and unsecured creditor claims were treated collectively. However, if there is a significant reduction in revenue due to the abolition of tax priority, the government may have to diversify against the risk of insolvency by increasing tax rates. Effectively, to achieve this, there will be a tax shift from tax priority to another tax. The effects upon simplicity from the tax shift must be assessed and measured in order to be able to determine which tax is simpler to administer. In that regard, the tax system will be simpler if a simpler tax is introduced in place of tax priority. A tax will be simpler if it is easier for taxpayers to understand their obligations, places taxpayers in a position where they are likely to make the most beneficial choices for themselves and respond to intended policy signals and lowers compliance costs for taxpayers.[501]

Evaluating the Commissioner's Role as an Unsecured Creditor within the Framework

The above analysis has considered the role that the Commissioner should play as preferred creditor within the Framework. It is clear that the answer to this question

[500] Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988) 300-301.
[501] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.

cannot be conclusively determined. It may be that the answer to this question can be found in quantifying the loss to the revenue from tax priority's removal. The extent of the revenue loss will materially impact upon the criteria of fiscal adequacy, efficiency and equity and is therefore central to the discussion of whether the Commissioner's unsecured creditor status meets the criteria within the Framework.

Without this data, there are two possibilities that must be analysed. Firstly, that the loss to the revenue from abolishing tax priority is minimal or revenue neutral and secondly, that the loss to the revenue from abolishing tax priority is significant. If the loss to the revenue is minimal or revenue neutral, then the fiscal adequacy criterion will not be affected, so consideration must be given to the remaining criteria within the Framework.

In relation to the efficiency criterion, abolishing priority will lead to a more effective insolvency procedure. Further, given the minimal loss to the revenue, the government will not have to diversify against the risk of insolvency, and accordingly a tax shift will not be necessary. In that regard, given the distortionary effects of imposing a tax priority, abolishing tax priority will be more efficient than imposing a tax priority in corporate insolvency.

Similarly to the efficiency criterion, the equity criterion would not be adversely affected. In that regard, as there would be minimal revenue loss, there would be minimal diversification necessary and therefore minimal adverse distributive consequences resulting from tax priority's removal. Further, the corporate rescue and simplicity criteria both clearly favour a system where there is no tax priority

and where all unsecured creditors, including the Commissioner, are treated equally. Accordingly, if the corporate rescue and simplicity gains from the removal of priority can be achieved with minimal cost to the revenue, there is a strong argument that the Framework supports the current system which treats the Commissioner as a general unsecured creditor.

If the loss to the revenue from abolishing tax priority is significant, the fiscal adequacy requirement will be adversely impacted and the government will have a number of options that it can consider to ensure this requirement can be met and that the loss to the revenue is mitigated. These measures may include reinstating tax priority, protecting the Commissioner's position with increased administrative and enforcement powers, or alternatively diversifying against the insolvency risk by implementing some form of tax shift. If tax priority is reinstated, then this will adversely impact on the efficiency, corporate rescue and simplicity criteria which have driven the trend toward the abolition of tax priority and such an outcome would be undesirable. Further, coupled with Australia's history leading to the abolition of tax priority, it is unlikely that tax priority will be reinstated, even if the loss to the revenue from the removal of tax priority is significant.

The administrative and enforcement powers of the Commissioner, although not considered in this chapter, are where the Commissioner plays his principal role in a corporate insolvency in Australia. The Commissioner routinely turns to these powers in order to achieve revenue neutrality as a result of his loss of tax priority in a corporate insolvency. These powers available to the Commissioner will be considered in later chapters. In particular, the impact of this role of the

Commissioner against the criteria of fiscal adequacy, corporate rescue, equity, efficiency and simplicity must be analysed to determine the effectiveness of the Commissioner in his pursuit to achieve revenue neutrality.

Finally, the third option which is often overlooked as evidenced by the lack of research in this area is the implementation of a tax shift from the abolition of corporate insolvency tax priority. In that regard, even if there is considerable loss to the revenue from removing tax priority, then provided that diversification of the risk occurs so that the tax shift is efficient and so that the distributive consequences are progressive in nature, arguably all of the criteria within the Framework can still be achieved. Of course, the effects to taxpayers' behaviour, including morale, will need to be considered as this can also impact on each of the criteria within the Framework.

Accordingly, based on the analysis of the Framework above, the argument against tax priority is stronger than the argument for re-introducing tax priority though not without qualifications. In that regard, more research must be undertaken to ascertain the extent of the loss to the revenue from the abolition of tax priority, and if the loss is considered to be material, then further research must be conducted in order to determine the most equitable, efficient and simple manner in which to create revenue neutrality.

Conclusion

This chapter considered one of the fundamental questions in relation to the role of the Commissioner in a corporate insolvency. That is, should the Commissioner be

given preferred creditor status? Law reform commissions and commentators in Australia and industrialised countries around the world have considered many of the criteria within the Framework in ad hoc manner, in making uniform recommendations to abolish tax priority. This chapter has extended the discussion further by considering the current position of the Commissioner as a general unsecured creditor in a corporate insolvency against the Framework in a systematic and theoretical manner.

An analysis of this role of the Commissioner against the Framework favours a corporate insolvency tax where the Commissioner does not have tax priority, however such a conclusion is qualified. In that regard, additional research must be conducted to determine the extent of the loss to the revenue as a result of the abolition of tax priority. If the loss to the revenue is not material, the Framework favours the removal of tax priority in a corporate insolvency and the treatment of the Commissioner as a general unsecured creditor. However, if the loss to the revenue is significant the government must put in place measures to either collect revenue from the insolvent company through its administrative and enforcement powers or alternatively, through diversifying its insolvency risk through a tax shift. It is clear that the optimum measure to be taken is that which best achieves the criteria within the Framework.

The next chapter will consider the ATO's insolvency debt collection framework. The chapter discusses the position of a corporate tax debtor that is approaching insolvency or that is insolvent within the ATO's debt collection framework. The chapter assesses the ATO's administrative practices in relation to these tax debtors

by applying the Framework, highlighting areas of weakness, and then draws upon the international experience to discuss possibilities for future action. An analysis of this role of the Commissioner in a corporate insolvency is imperative given that this is the role that the Commissioner must turn to in order to achieve the fiscal adequacy requirement in light of the loss of tax priority.

Chapter 5 - The ATO's Insolvency Debt Collection Framework

Introduction

Australia has abolished all statutory tax priorities. Accordingly, the Commissioner is a general unsecured creditor in insolvency proceedings. While the Commissioner is at a disadvantage in relation to being a non-consensual, unsecured creditor, there are considerable advantages that the Commissioner has over other general unsecured creditors and in some instances even secured creditors. The Commissioner is able to take advantage of his role to administer the tax laws by exercising his extensive powers for assessment of tax liability, and the collection of the tax due from a valid assessment. The collection and recovery of unpaid tax-related liabilities and other related amounts is covered by a common set of rules in Part 4-15 of Schedule 1 to the TAA 1953.

In addition to this legislative scheme, the ATO has provided administrative guidance as to the operation of the legislation by way of Law Administration Practice Statements (PS LAs), which prescribe the ATO's view on the operation of the legislative provisions. The manner in which the ATO engages with taxpayers in the administration of the legislative scheme can be as important as the content of the legislation itself.[502] In the context of a corporate tax debtor approaching insolvency, the efficacy with which the ATO collects tax debts can significantly impact on a number of stakeholders, including the tax debtor, general creditors and

[502] Australian Government Productivity Commission, *Regulator Engagement with Small Business*, Research Report (2013) 86.

competitors of the tax debtor as well as more broadly impact upon Australia's voluntary tax compliance regime, government policy and the provision of services for Australians.[503]

This chapter will describe the ATO's insolvency debt collection framework, including the number of debt collection strategies that the ATO has developed. The chapter will then discuss where a corporate tax debtor approaching insolvency or that is insolvent is likely to fall within the ATO's debt collection framework. Finally, consideration will be given to whether the ATO's administrative practices fall within the Framework, highlighting areas of weakness, and will then draw upon the international experience to discuss possibilities for future action.

The scope of this chapter is limited to the ATO's insolvency debt collection framework in the context of the tax collection and recovery processes of the ATO when dealing with definite and undisputed debt. This chapter does not consider the ATO's approach in relation to dealing with an insolvent tax debtor with disputed debt. Further, this chapter does not consider comprehensively how the ATO's enforcement tools or third party liabilities would operate with respect to an insolvent tax debtor. These issues will be explored in later chapters.

Background

The GFC had a considerable impact on the Australian economy resulting in decreases in net revenue in 2008-2009 and 2009-2010, and coupled with this, a

[503] Ibid.

further increase in the level of collectable debt.[504] Post the GFC, the Australian economy is still experiencing economic uncertainty due to the volatility of global financial markets.[505] The ATO's most recent annual report shows tax debt increased 10 per cent from $17.7 billion in 2012 to 2013 to $19.2 billion in the last financial year.[506] This was despite collections attributable to ATO debt collection actions increasing by 4.7% compared to the previous financial year.[507] Small businesses account for over 60% of total collectable debt with SMEs accounting for almost the total amount of collectable debt.[508] Accordingly, small business is a specific area of focus of the ATO.[509] In this environment the ATO is carefully managing the way in which it conducts its debt collection activities in order to ensure that debt levels remain acceptable.[510]

In the international context, it has been estimated that the OECD governments alone were owed around two thirds of a trillion US dollars in undisputed tax debts at the end of 2013.[511] Accordingly, in both the Australian and international contexts, the management of tax debt is a major concern for revenue authorities.

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[504] FCT, *Annual Report 2008–09* (2009) 47, 53; FCT, *Annual Report 2009–10* (2010) 37, 50.
[505] FCT, *Annual Report 2013-14* (2014) 14.
[506] FCT, *Annual Report 2014-15* (2015) 44.
[507] FCT, *Annual Report 2014-15* (2015) 35.
[508] Ibid; Australian National Audit Office, *The ATO's Administration of Debt Collection—Micro-business*, Auditor General Audit Report No.42, Performance Audit (2006–07) 35; Construction is the largest industry component of the small business collectable debt. Construction entities comprise 11.3% of the small business population and owe 23.1% of the total small business collectable debt. The top five industries of small business collectable debt are construction, professional, scientific and technical services, financial and insurance services, rental, hiring and real estate services and accommodation and food services.
[509] FCT, *Annual Report 2013-14* (2014) 49.
[510] Australian National Audit Office, *Audit Work Program* (2012) Section 2, ATO.
[511] OECD, *Working Smarter in Tax Debt Management* (2014) Executive Summary.

Two inquiries have recently been undertaken in Australia which concern issues relating to the ATO's debt management problems. Following community consultation, on 10 April 2014, the IGT announced his new work program for improving tax administration in Australia.[512] During the consultation process there were significant concerns raised with the ATO's approach to debt collection. Major sources of dissatisfaction included delayed recovery action, disproportionate action when debts are pursued and the use of external debt collection agencies (EDCAs).[513] Many of these concerns were also raised in the IGT's earlier review into the Tax Office's Small Business Debt Collection Practices.[514] Complaints to the Commonwealth Ombudsman relating to debt collection accounted for 23% of all complaints received by him in 2013, and attracted significant media attention.[515] The IGT's review examined these stakeholder concerns and also considered broader ATO debt collection functions including the use of administrative and legislative instruments such as garnishee notices and director penalty notices, its approach to the debtor and the debtor's creditors during insolvency actions, the re-raising of 'written-off' debts, debt relief decisions and payment arrangements.[516] The second inquiry into tax disputes was referred to by the Minister for Finance and Acting Assistant Treasurer, Senator the Hon Mathias Cormann, and adopted by the Standing Committee on Tax and Revenue on 4 June

[512] IGT, *New IGT Work Program* (2014).
[513] IGT, *Annual Report 2013-14* (2014), 6.
[514] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 13-14.
[515] IGT, *Annual Report 2013-14* (2014) 6.
[516] Ibid.

2014. The Committee inquired into and reported on disputes between taxpayers and the ATO, with particular regard to collecting revenues due.[517]

The Legislative Framework

One category of compliance action undertaken by the ATO is that of debt collection. A debt will arise when 'a tax, duty or charge becomes due and payable, that is, deemed by law to be due to the Commonwealth and payable to the Commissioner'.[518] Section 47 of the *Financial Management and Accountability Act 1997* (Cth) governs the management and collection of tax debts. That section states that a Chief Executive Officer (CEO) must pursue each debt for which the CEO is responsible unless the debt has been written off as authorised by an Act; or the CEO is satisfied that the debt is not lawfully recoverable; or the CEO considers that the recovery of the debt is not economical.[519] Part 4-15 of Schedule 1 to the TAA 1953 provides a collective set of rules for the collection and recovery of tax debts and other related amounts. An in-depth analysis of the legislative framework will occur in later chapters.

Tax Debtor Engagement with the ATO

The ATO's Position

In addition to this legislative scheme, the ATO has provided administrative guidance as to the operation of the legislation by way of PS LAs, which prescribe the ATO's

[517] Parliament of Australia, *Inquiry into Tax Disputes* (2014), Terms of Reference.
[518] Australian National Audit Office, *Management of Debt Relief Arrangements*, Auditor General Audit Report No.52 (2012) 24.
[519] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 47.

view on the operation of the statutory scheme. Further, the ATO's debt management strategies are underpinned by the ATO's Compliance Model, Enterprise Risk Management Framework (ERMF) and Debt Management Framework (DMF).

ATO Policies

The primary ATO PS LAs which concern the administration and enforcement of an insolvent entity's tax debts include:

- PS LA 2011/6 – Risk and risk management in the ATO;
- PS LA 2011/14 – General debt collection powers and principles;
- PS LA 2011/16 – Insolvency – collection, recovery and enforcement issues for entities under external administration; and
- PS LA 2011/18 – Enforcement measures used for the collection and recovery of tax related liabilities and other amounts.

The ATO's PS LAs set out in more detail the ATO's approach to debt collection and lodgement matters. PS LA 2011/14, *General debt collection powers and principles*, provides that the ATO expects tax debtors to pay their debts as and when they fall due for payment because the ATO 'is not a lending institution or credit provider; expects tax debtors to organise their affairs to ensure payment of tax debts on time, and to give their tax debts equal priority with other debts.'[520]

[520] ATO, PS LA 2011/14 *General Debt Collection Powers and Principles*.

PS LA 2011/6, *Risk and risk management in the ATO*, provides that 'all taxpayers will be treated professionally, equitably and fairly'; 'taxpayers can expect each case to be considered on its merits'; and 'taxpayers can expect the ATO to apply the most severe measures and sanctions in response to the highest level of risk in accordance with [its] compliance model'.[521]

The private sector has criticised the ATO's policies and practices on the basis that:[522]

- they do not appropriately balance the competing interests of the major stakeholders including the debtor, other creditors and the ATO;
- they do not sufficiently consider the underlying viability of small businesses;
- the policies were developed without sufficient consultation with the business sector;
- there is poor awareness of the policies;
- there is a lack of certainty and transparency as to the ATO's processes and timeframes for collection of debt; and
- they do not uniformly apply the relevant policies, resulting in inequities and unfair or disproportionate debt collection responses in individual cases.[523]

[521] ATO, PS LA 2011/6, para 37.
[522] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 51.
[523] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 10.

In contrast to the private sector views, the Taxation Ombudsman has commented that, from his observation, the 'ATO receivables policy' (now PS LAs) would appear adequate to address any issues around small business tax debt collection.[524] For example, the Taxation Ombudsman comments that the ATO's policies set out comprehensive guidelines for negotiating payment arrangements, remission of interest and penalties, and legal recovery action, including the use of garnishees, bankruptcy and liquidation.[525]

Compliance Model

The ATO's Compliance Program prescribes the ATO's 'compliance responsibilities, strategies and actions', including securing payment compliance as well as highlighting areas of perceived compliance risks and its strategies targeted at addressing those risks.[526] The compliance model was first officially publicised by the ATO in its large business and compliance publication in 2000 and was implemented in the early 2000s.[527]

The Compliance Program is underpinned by the 'enforcement pyramid' of the ATO's Compliance Model.[528] Essentially, those taxpayers that are persistently non-compliant are situated at the top of the pyramid, while those taxpayers who are generally compliant are situated toward the bottom of the pyramid. Taxpayers

[524] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 51.
[525] Ibid.
[526] IGT, *Review into aspects of the ATO's use of compliance risk assessment tools*, Report to the Assistant Treasurer (2013) 16, 106.
[527] Robert Whait, 'Developing Risk Management Strategies in Tax Administration: The Evolution of the Australian Tax Office's Compliance Model' (2012) 10(2) *eJournal of Tax Research* 437, 438.
[528] IGT, *Review into aspects of the ATO's use of compliance risk assessment tools*, Report to the Assistant Treasurer (2013) 16.

situated at the top of the pyramid are subjected to the ATO's more severe sanctions while those situated at the bottom of the pyramid are encouraged to engage in 'cooperative compliance' with the ATO.[529]

The model combines 'responsive regulation' and 'motivational posturing theories'.[530] 'Responsive regulation' is a theory that describes and prescribes how a regulator can use enforcement strategies to facilitate compliance.[531] It proposes that in order to achieve this objective, that enforcement action should not be used solely as a deterrent or solely as a cooperative measure. In the tax compliance context, 'motivational posturing' theory is based upon the premise that taxpayers place social distance between themselves and the ATO so as to protect themselves from negative appraisal by the ATO.[532] Together, the models advocate that compliance can be made easier through improved customer service and education in addition to the traditional deterrence strategies. The ATO adopts strategies such as using behavioural economics principles when drafting its debt letters and scripting, targeting education and communication and developing online tools to improve the level of customer service and education to positively influence voluntary compliance.[533] Over recent years, the ATO's use of tailored correspondence using behavioural economics toward the tax debtor's perceived

[529] Commonwealth Ombudsman, *ATO Administration of Garnishee Action*, Report No.1/2007 (2007) 3.
[530] Robert Whait, 'Developing Risk Management Strategies in Tax Administration: The Evolution of the Australian Tax Office's Compliance Model' (2012) 10(2) *eJournal of Tax Research* 437, 438-452.
[531] Ibid.
[532] Ibid.
[533] OECD, *Working Smarter in Tax Debt Management* (2014) 44; ATO, *GST Administration Annual Performance Report 2013-14* (2014); ATO, *Online Services*, available at https://www.ato.gov.au/general/online-services/ at 12 July 2016.

risk profile is one strategy that has contributed to increases in the amount of debt collected and improvements in the efficiency and effectiveness of debt collection. For example, as a result of a successful trial in 2013, the ATO phased out a payment reminder letter and replaced it with a revised version based on behavioural insights. Over a 30 day period, this resulted in a 5.1% increase in payments in full for Business Activity Statement (BAS) debts and a 3.4% increase in payments in full for income tax debts.[534] Additionally, behavioural insights helped the ATO refine a debt collection warning letter prompting taxpayers to take immediate action to address their debt resulting in a 12.6% increase in payments in full for BAS debts, and a 12.1% increase in payments in full for income tax debts.[535] In order to create a high level of trust and engagement between the taxpayer and the ATO and to minimise defensive responses by taxpayers, strategies aimed at increasing rates of compliance should be aimed at education and persuasion.[536] Once these strategies have been exhausted, then the sanctioning of non-complying individuals occurs.[537]

The 'BISEP' (business, industry, sociological, economic, and psychological (BISEP) model was also developed to sit alongside the compliance pyramid to allow the ATO to consider the qualitative factors of the taxpayer when determining its response to non-compliance.[538] The compliance model has been described by

[534] FCT, *Annual Report 2013-14* (2014), 51.
[535] Ibid.
[536] Ibid.
[537] Duncan Bentley, 'Problem Resolution: Does the ATO Approach Really Work?' [1996] 6 *Revenue Law Journal* 17; Pauline Niemirowski, Steve Badlwing and Alexander J. Wearing, 'Tax Related Behaviours, Beliefs, Attitudes and Values and Taxpayer Compliance in Australia' (2003) 6(1) *Journal of Australian Taxation* 132.
[538] Robert Whait, 'Developing Risk Management Strategies in Tax Administration: The Evolution of the Australian Tax Office's Compliance Model' (2012) 10(2) *eJournal of Tax Research* 437, 438.

some commentators as a significant shift from the traditional regulatory approach of the ATO which was focussed on recovery and enforcement actions.[539]

Enterprise Risk Management Framework

One of the considerable challenges for the ATO is to ensure that its debt collection practices operate efficiently so that resources are channelled into those areas that present the greatest compliance risk whilst ensuring that its policies and practices are equitable and deliver uniform responses.[540] In order to achieve this objective, the ATO utilises an ERMF to make assessments and manage all 'enterprise risks'.[541] Corporate Management Practice Statement (PS CM) 2003/02 'Risk and issues management' provides that the aim of the ERMF is to ensure '[a] consistent, effective and integrated approach to the overall management of risks and issues at all levels to enable the ATO to achieve its outcome, deliver on government commitments and meet legislative obligations.' [542]

The Australian Government Productivity Commission Report on Regulator Engagement with Small Business stated that 'using a risk based approach to guide compliance and enforcement resources is likely to result in the greatest gains for the community in regulatory areas where businesses present diverse risks, such as in the area of… taxation'.[543] Similarly, in an international context, guidance from

[539] Valarie Braithwaite, *A New Approach to Tax Compliance* (Ashgate Publishing Ltd, Aldershot, UK, 2003) 1.
[540] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 10.
[541] IGT, *Review into aspects of the ATO's use of compliance risk assessment tools*, Report to the Assistant Treasurer (2013) 6.
[542] ATO, PS CM 2003/02 *Risk and issues management* (2013).
[543] Australian Government Productivity Commission, *Regulator Engagement with Small Business*, Research Report (2013) 106.

the OECD Committee on Fiscal Affairs has also advocated that revenue authorities adopt a risk management approach.[544]

In 2011, the ATO replaced the former 'risk engine' which relied upon a relatively simple approach where cases were primarily prioritised on the basis of the age and size of debts with a contemporary integrated risk-based approach.[545] This new approach was developed and implemented as part of the 'Debt Right Now' (DRN) program.[546] The key innovations from this project included an integrated end-to-end platform that takes a whole-of-ATO approach to debt collection, the development of contemporary, evidence-based risk assessment models and a risk-based decision-making framework.[547]

The models incorporate a large number of variables, including the filing and payment history of taxpayers.[548] The principal analytical risk models are propensity to pay (P2P) and capacity to pay (C2P).[549] The P2P predicts the probability of the taxpayer paying all outstanding liabilities in full within a certain time interval and the C2P predicts the financial capacity of the taxpayer to pay their debt against the likelihood of insolvency in the next 12 months.[550] The analysis of these two risk models are combined to create a risk score.[551]

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[544] OECD, Centre for Tax Policy and Administration, *General Administrative Principles - GAP003 Risk Management* (2001) para 10.
[545] IGT, *Review into aspects of the ATO's use of compliance risk assessment tools*, Report to the Assistant Treasurer (2013) 108.
[546] OECD, *Working Smarter in Tax Debt Management* (2014) 31.
[547] Thomas Ryan, Assistant Commissioner, *Case Study: The DRN project*, Debt for the ATO, Public Sector Efficiency Conference, Brisbane, October 2012.
[548] OECD, *Working Smarter in Tax Debt Management* (2014) 31.
[549] Ibid.
[550] Ibid.
[551] Ibid.

Based on the ATO's risk differentiation framework, 86 per cent of SMEs are classified as low risk taxpayers and therefore receive less attention from the ATO, 11 per cent are categorised as a medium risk and 3 per cent as high risk.[552] The application of this form of 'advanced analytics' makes it possible for the ATO to use the rich data that it collects about each taxpayer to determine when to intervene and the best form of intervention, thereby eliminating the cost of ineffective interventions and decreasing levels of collectable debt.[553] While the DRN program has improved debt collection effectiveness and efficiency, the improvement has not been enough to reduce levels of collectable debt.[554] In that regard, there remains a focus of the ATO to continue to further develop its models to better target debt collection strategies. For example, a recent OECD report states that the ATO is working with a major Australian university on the development of predictive models that will combine with the existing models to form a more advanced risk framework.[555]

While the ERMF is clearly an integral part of the ATO's debt collection process, the private sector has criticised the risk methodology which is employed by the ATO, commenting that 'it would be helpful to better understand the way in which that risk methodology actually works in order to help clarify some of the seemingly odd

[552] Australian Government Productivity Commission, *Regulator Engagement with Small Business*, Research Report (2013) 98.
[553] On 18 May 2011, the ATO commenced the DRN pilot for SGC debt collection. Due to the success of the pilot, it has become a part of the ATO's 'business as usual' process for SGC debt collection; IGT, *Review into aspects of the ATO's use of compliance risk assessment tools*, Report to the Assistant Treasurer (2013) 111.
[554] OECD, *Working Smarter in Tax Debt Management* (2014) 31.
[555] Ibid.

choices which the ATO sometimes makes about who to pursue and how to pursue.'[556]

Debt Management Framework

The ATO has in place a DMF that is based on three elements, namely early collections, firmer action and strategic recovery.[557] The first element of the ATO's framework for managing debt focuses on early intervention as aged debt is more difficult and more expensive to follow-up.[558] Early intervention is considered necessary in helping businesses to resolve their debts. In that regard, when further tax debts are accumulated, the likelihood of the tax debt remaining outstanding over 12 months and becoming a bad or doubtful debt almost triples.[559] Some practitioners are of the view that intervention by the ATO is too tardy, resulting in failed businesses that continue to trade to the detriment of all creditors.[560] The Australian Restructuring Insolvency and Turnaround Association (ARITA) comments that one of its members saw an extreme 11 repayment arrangements entered into with a tax debtor prior to any firmer action being taken by the ATO.[561] This can also extend to the ATO agreeing to excessive court adjournments of winding up or

[556] Taxpayers Australia Inc., *Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014) 3.
[557] Australian National Audit Office, *The Engagement of External Debt Collection Agencies,* Auditor General Audit Report No.54, Performance Audit (2012) 14.
[558] Ibid 16. Aged debt is defined by the ATO as debt outstanding for more than two years.
[559] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 19.
[560] ICA, *Submission to IGT Work Program 2014 and Beyond* (2014); Michael Murray, *'ARITA's Views on the ATO'* (2014); IGT, *Review into the ATO's Approach to Debt Collection* (2014) Terms of Reference and Submission Guidelines.
[561] ARITA, Submission to the IGT, *Review into the ATO's Approach to Debt Collection* (2014) Appendix.

creditors petitions over a long period.[562] Similar concerns were expressed in the IGT's Review into the Tax Office's Small Business Debt Collection Practices.[563]

The second element of the ATO's framework focuses on firmer action. The ATO states that its general position on debt collection is that 'it gives people the opportunity to work with the ATO to clear their tax debts before it takes firmer or legal action that is difficult and costly for all involved'.[564] In its 2012 to 2013 Annual Report, the ATO stated 'we took firmer action to recover debts where taxpayers were unwilling to work with us, continually defaulted on agreed arrangements, or did not have the capacity to pay and failed to take steps to resolve their situation.'[565]

The ATO states that firmer action may include garnishee notices, director penalty notices, statutory demands, court processes such as bankruptcy or winding up proceedings, issuing a writ/warrant of execution authorising the seizure and sale of taxpayer property to pay a judgment debt plus costs.[566] In rare circumstances, the ATO may require the tax debtor to pay a bond or provide security in respect of any tax-related liability.[567]

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[562] Ibid.
[563] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 4, 80, 91.
[564] Australian National Audit Office, *The Engagement of External Debt Collection Agencies,* Auditor General Audit Report No.54, Performance Audit (2012) 38.
[565] FCT, *Annual Report 2012-13* (2013) 46.
[566] Australian National Audit Office, *The Engagement of External Debt Collection Agencies,* Auditor General Audit Report No.54, Performance Audit (2012) 38; ATO, Firmer Action Approach to Debt Collection available at http://www.ato.gov.au/Individuals/Payments-and-refunds/In-detail/Having-difficulty-paying-on-time/Firmer-action-approach-to-debt-collection/ on 21 May 2014.
[567] Ibid.

The third element of the ATO's framework is concerned with identifying instances where there is greater risk of a debt not being recovered. For example, a business may be considered not to be viable in the longer term or where 'phoenix' activity is involved.[568] In these instances, the ATO may take strategic recovery action, including initiating winding up proceedings.[569]

Engagement with Small Business[570]

There are a number of factors that impact upon small business, making it more difficult for the ATO to engage with small businesses compared with larger businesses.[571] There are a number of factors that influence the small business sector's compliance with tax payment obligations and these factors are more pronounced in businesses that have an outstanding tax debt. These factors include:

- difficulties with cash flow management (short-term and long-term);[572]
- inability to recognise the importance of tax obligations and to comply with them in a timely and accurate manner;[573]

[568] Ibid.
[569] Australian National Audit Office, *The Engagement of External Debt Collection Agencies,* Auditor General Audit Report No.54, Performance Audit (2012) 13.
[570] The ATO defines micro businesses as those businesses with an annual turnover below $2 million. They employ one in five Australian workers and account for more than a quarter of tax revenue collected, including approximately $14 billion in PAYG withholding tax for their employees. There are approximately 2.8 million micro businesses in this market segment; ATO, *Compliance Program 2012-13*, Microenterprises (2013). SME taxpayers are those entities with an annual turnover between $2 million and $250 million. This particular market segment comprises a diverse group of businesses such as closely held private groups, foreign owned multinational corporations, charities, sole traders and partnerships; ATO, *Tax compliance for SMEs and wealthy individuals* (2012).
[571] Ibid, 146.
[572] Australian National Audit Office, *The ATO's Administration of Debt Collection—Micro-business*, Auditor General Audit Report No.42, Performance Audit (2006–07) 19.
[573] Eliza Ahmed and Valerie Braithwaite, 'Understanding Small Business Taxpayers: Issues of Deterrence, Tax Morale, Fairness and Work Practice' (2005) 23(5) *International Small Business Journal* 539.

- persistent and deliberate culture of avoidance of tax obligations, particularly as high competition increases;[574]
- high frequency of cash transactions;[575]
- number of small businesses deeming auditing difficult and ATO enforcement action is often met with public criticism;[576]
- limited access to finance;[577]
- dealing with big business;[578]
- competition with non-compliant businesses and the regulatory burden on small businesses;[579]
- poor-record keeping;[580]
- intertwining of business and personal affairs;[581]

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[574] A study has been conducted showing that small businesses consider tax flight to be a fair way to reduce tax burden, Eric Kirchler, Boris Maciejovsky and Friedrich Schneider, 'Everyday representations of tax avoidance, tax evasion, and tax flight: Do legal differences matter?' (2003) 24 *Journal of Economic Psychology* 535, 547 to 548.
[575] Eliza Ahmed and Valerie Braithwaite, 'Understanding Small Business Taxpayers: Issues of Deterrence, Tax Morale, Fairness and Work Practice' (2005) 23(5) *International Small Business Journal* 539.
[576] Ibid.
[577] International Finance Corporation Advisory Services, *Access to Credit among Micro, Small, and Medium Enterprises* (2013).
[578] Ellis Connolly, David Norman and Tim West, *Small Business: An Economic Overview*, Small Business Finance Roundtable (May 2012) 12.
[579] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 119.
[580] Phil Lignier, Chris Evans and Binh Tran-Nam name record-keeping as a 'driver behind tax compliance costs' in 'Tangled up in tape: the continuing tax compliance plight of the small and medium enterprise business sector' (2014) 29 *Australian Tax Forum* 217, 223.
[581] A study by Lynley Woodward and Lin Mei Tan shows the occurrence of both intentional and unintentional misclassification of business and personal expenses. See Lynley Woodward and Lin Mei Tan, 'Small business owners' attitudes toward GST compliance: a preliminary study' (2015) 30 *Australian Tax Forum* 517, 541 to 542.

- fluctuating profitability and a constant need for working capital to maintain viability;[582] and

- inadequate knowledge of tax law.[583]

The Council of Small Business Australia stated in its response to the Productivity Commission's Study into regulator engagement with small business commented that 'The ATO is a prime example of an agency who engages with industry. The ATO has various consultative forums where they actively seek information and advice ... They consult with industry at all levels and they get the difference between big and small business.' [584]

The IGT also observes that there are significant differences between the large business market and the SME market and as such this will require different ATO approaches.[585]

The ATO has introduced a number of initiatives aimed at achieving greater engagement with small business during its debt collection activities. For example, in May 2014 the ATO began trialling email payment reminders for taxpayers with a payment arrangement for their tax debts and in response to taxpayers' feedback, the ATO are now developing a short message service (SMS) payment reminder

[582] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 10.
[583] Margaret McKerchar, 'Understanding Small Business Taxpayers: Their Sources of Information and Level of Knowledge of Taxation' (1995) 12 *Australian Tax Forum* 25-41; Cynthia Colemand and Lynne Freeman, 'Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance' 13 *Australian Tax Forum* 311-336.
[584] FCT, *Annual Report 2012-13* (2013) 21.
[585] IGT, *Review into aspects of the ATO's use of compliance risk assessment tools*, Report to the Assistant Treasurer (2013) 117.

service.[586] The ATO has implemented a number of self-help tools designed to make entering into a payment arrangement as easy as possible. For example, business taxpayers can enter into a payment arrangement using automated telephone services for debts up to $25,000.[587] An online service should be available for businesses and BAS debts and superannuation debts in the near future.[588] These services are complemented by other digital tools, including a payment arrangement calculator and a payment plan estimator mobile app.[589]

The ATO has a number of initiatives in place aimed at improving the small business taxpayers' online experience. For example, Small Business Assist was launched in July 2013[590] and a Tax Time app for small business in late 2013.[591] These tools offer functionality for determining SGC eligibility, performing SCG, tax withheld and fuel tax credit calculations and include checklists, employee/contractor tools and a payment plan estimator.[592] 'Tax tips for Australian business' is available on the ATO website and includes suggestions as to how business owners can better manage their business to avoid debt, as well as encouraging them to contact the ATO if they are having difficulty meeting their tax obligations.[593] Further, the ATO is planning to introduce a small business 'newsroom' which will allow subscribers to tailor the information they receive from the ATO and the mode in which they receive it.

[586] FCT, *Annual Report 2014-15* (2015) vi, 13, 31.
[587] ATO, *'Managing Your Tax Debt'* available at https://www.ato.gov.au/printfriendly.aspx?url=/general/managing-your-tax-debt/ on 20 May 2015.
[588] Ibid.
[589] OECD, *Working Smarter in Tax Debt Management* (2014) 41
[590] FCT, *Annual Report 2012-13* (2013) 23, 25.
[591] Ibid 26.
[592] ATO, *ATO IT strategy* (2014).
[593] OECD, *Working Smarter in Tax Debt Management* (2014) 46.

Subscribers will be able to receive tax and superannuation news and alerts, watch short video clips, add tax dates to their calendars to create reminders and share articles with each other. Another measure is 'click to chat' which is currently in the pilot stage and will allow small business owners to have a real-time, online conversation with an ATO customer service officer, who will be able to provide guidance on particular topics and additional information to the taxpayer.[594] Additional engagement with small business occurs via social media and promotional campaigns to help taxpayers meet their tax obligations and in one-on-one assistance visits.[595]

While these are positive reports and initiatives in relation to the ATO's engagement with the small business sector, a number of industry groups have been very critical of the ATO's approach to small business debt collection.[596] Industry comments that there has been a 'noticeable firming in the ATO's approach to debt collection' which stands in contrast to the flexibility that was offered by the ATO immediately post the GFC.[597] This firmer approach is perceived to be unjustified as in many sectors business confidence and sustainability has remained unchanged since 2008.[598]

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[594] Ibid.

[595] Michael DÁscenzo, 'Promoting Tax Excellence – An Essential Ingredient for a Prosperous Community' (Speech delivered at the Curtin University Taxation Seminar, 30 October 2012).

[596] ARITA*, Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014); ICA, *Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014); Taxpayers Australia Inc., *Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014).

[597] Taxpayers Australia Inc., *Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014).

[598] Media reports state 'The federal government is cracking down on business and using the ATO as a weapon to claw back revenue to help plug the federal budget deficit' in Adele Ferguson, 'Taxman Wields Axe On Small Business'*, Sydney Morning Herald*, Business Day, August 9 2013 and 'The ATO has worked closely with the small business sector in the past to deal with the implications of the GFC. But….it started to tighten a few years ago. It is a little bit tighter again this year' in Jason Clout, 'Tax Bills Surge as ATO Tracks SME Payments'*, Australian Financial Review*, 14 Aug 2013.

Another major area of concern to small business includes the use of third party debt collectors. Submissions made to the IGT as part of the ATO's recent Review into the ATO's Approach to Debt Collection reveal that the private sector is of the view that the ATO should not outsource its debt collection function to third party debt collectors.[599] Further, stakeholders who are not adverse to the use of third party debt collectors are still critical of the policies, procedures and practices that they employ.[600] The grounds for this criticism include that third party debt collectors are inefficient, that they pose security and privacy risks and that they are using out of date data resulting in poor communication.[601]

Assessment of Business Viability

Where a business is experiencing cash flow problems, the ATO is often the last creditor to be paid and the business may be signalling potential insolvency.[602] The assessment of viability and financial risk plays an important role in determining a taxpayer's ability to address its tax debt and comply with its ongoing tax obligations. A recent Productivity Commission Report recommended that governments should not seek to support small businesses that are no longer sustainable over the long term.[603]

[599] IGT, *Debt Collection, A Report to the Assistant Treasurer* (2015) 137.
[600] Taxpayers Australia Inc., *Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014).
[601] Ibid 5.
[602] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 18.
[603] Australian Government Productivity Commission, *Regulator Engagement with Small Business*, Research Report (2013) 95.

The IGT's Report into the ATO's Small Business Debt Collection Practices, published in 2005, makes a number of references in relation to the lack of ATO concern regarding assessing the viability of a business prior to taking legal action against a tax debtor.[604] The Report states that the ATO is of the view that 'a business's viability is not a matter they (Senior Tax Officials) can accurately determine, nor should they', that 'the ATO is concerned with the risk of non-payment of tax debts, not businesses' viability'[605] and 'that it (the ATO) is neither in the business of assessing a small business's viability nor does it have the resources to encourage all non-compliant businesses to seek advice.'[606] This attitude of the ATO is contrary to the views expressed by the IGT in that Report that they 'would have concerns if the ATO took action which would cause otherwise viable businesses to go into liquidation simply because of short-term cash flow problems or if the ATO implemented reactive measures to recover the outstanding collectable debt amounts within short time frames without considering the implications for the business sector'.[607] Similar views have been expressed by the Auditor General.[608]

The ATO's attitude to the assessment of business viability appears to have changed more recently. The ATO has developed a Business Viability Assessment Tool (BVAT) for SMEs which the ATO uses together with other information about taxpayers' individual circumstances to distinguish between viable businesses that may be

[604] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 10, 14, 18, 21.
[605] Ibid 53.
[606] Ibid, 79.
[607] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 19.
[608] Australian National Audit Office, *The ATO's Administration of Debt Collection—Micro-business*, Auditor General Audit Report No.42, Performance Audit 2006–07 (2007) 50.

undergoing short term financial difficulties, and businesses that may not be viable.[609] The BVAT is only used when firmer action is anticipated for those taxpayers that present the greatest risk and generally when a repayment plan is requested.[610] This tool is also available to taxpayers online and it is currently being further developed. While there have been positive reports from the ATO in relation to the use of this tool, stakeholders have questioned the ATO's reliance on the BVAT in determining debt recovery and assistance strategies.[611] The ATO has also developed an independent viability assessment process for large publicly listed companies.[612]

In 2010-11 the ATO also piloted the use of professional firms to conduct independent business viability assessments for businesses with complex financial arrangements and significant outstanding debt.[613] The ATO's Independent Viability Assessment program mirrors a similar program run by the UK's Her Majesty Revenue and Customs (HMRC) where taxpayers with debts of more than $1 million undergo a financial review by an external practitioner.[614] The initial ATO pilot demonstrated that an independent viability assessment can be beneficial.[615] However, as this initiative is at a pilot stage, it is uncertain as to whether it will be implemented in the future.[616]

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[609] ATO, Regional Tax Practitioner Working Groups, South East Queensland, Minutes, March 2013; ATO, Commissioner's Small Business Consultative Group, *Minutes*, October 2012.
[610] ATO, Regional Tax Practitioner Working Groups, Victoria, *Minutes*, March 2013.
[611] Michael Murray, *ARITA's Views on the ATO* (2014).
[612] Jonathon Sprott and Gerry Bean, 'ATO raises the bar on corporate governance and managing tax risk' (2005) 57(2) *Keeping Good Companies* 110.
[613] FCT, *Annual Report 2010-11* (2011) 84.
[614] ATO, Small Business Partnership, *Minutes*, 29 November 2012.
[615] Ibid.
[616] Ibid.

This change of attitude toward the assessment of business viability has not been reflected in the ATO's PS LAs. With the exception of garnishee notices, the ATO's PS LAs do not provide any reference in relation to the ATO taking into account the viability of the business as a factor prior to determining the appropriate action to be taken against a tax debtor.[617] Accordingly, the Commissioner can commence winding-up proceedings against a tax debtor without considering the business' long term viability.

Where does a company that is approaching insolvency fall within the ATO's Insolvency Debt Collection Framework?

Within the Compliance Model, Enterprise Risk Management Framework and Debt Management Framework, a corporate taxpayer that is approaching insolvency is likely to be experiencing financial difficulties and as such will have outstanding tax liabilities with the ATO. The corporate debtor will have considered the debt relief options available. The ATO comments that '[w]e offer help to viable businesses having trouble meeting their tax payment obligations due to such short-term difficulties.'[618] This help includes flexible payment arrangements that align with cash flow and remission of general interest charge (GIC) where appropriate.[619] At 30 June 2013, there were around 32,000 GIC-free payment arrangements in place to the value of almost $700 million.[620] While the ATO offers these payment

[617] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts*, para 102.
[618] ATO, *Help for Small Businesses Experiencing Short-Term Financial Difficulties*, available at https://www.ato.gov.au/Business/Business-activity-statements-%28BAS%29/In-detail/Lodgment-and-payment/Help-for-small-businesses-experiencing-short-term-financial-difficulties/ at 12 July 2016.
[619] Ibid.
[620] FCT, *Annual Report 2012-13* (2013) 12.

arrangements, submissions made to the IGT by the Institute of Chartered Accountants (ICA) in relation to the IGT Work Program for 2014 comment that 'their members have noticed increasing strain faced by some of their clients in the current economic environment as a result of the ATO's debt collection activities'.[621] The ICA's submission comments that '[t]here is a view that the ATO has been deploying a strong-arm approach to collecting tax debts. For example, by imposing a more stringent requirement such as a 50% up-front payment, rather than settle for a payment arrangement.'[622]

Another debt relief option includes entering into a compromise in which the ATO accepts a lesser amount from the tax debtor than the primary debt outstanding, in full and final settlement of an undisputed debt in circumstances where a taxpayer does not have the capacity to pay a debt in full.[623] However, taxpayers' representative bodies and tax practitioners raise the concern that the ATO's compromise policy is 'not commercial and has little or no regard for the ongoing viability or circumstances of a business'.[624] The ATO recognises the inflexibility of its compromise policy commenting that 'corporate debtors would probably seek an arrangement with creditors under Part 5.3A of the Corporations Act 2001 or go into liquidation, rather than agree to an ATO compromise.'[625] The final debt relief option available is a release from tax-related liabilities on the grounds that the tax

[621] ICA, *Submission to IGT Work Program 2014 and Beyond* (2014).
[622] Ibid.
[623] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 101.
[624] Ibid.
[625] Ibid.

debtor will suffer serious hardship if they are required to satisfy the liability.[626] However, this option is not available to corporate tax debtors. [627]

Accordingly, once these limited and quite inflexible debt relief options have been exhausted, the corporate tax debtor approaching insolvency is likely to be categorised by the ATO as a persistent non-compliant taxpayer, possibly with a poor lodgement and payment history that may include having defaulted on a number of payment arrangements. A viability assessment may or may not have been conducted by the ATO. A corporate taxpayer with this profile is likely to be categorised as high risk and therefore firmer action either has been initiated by the ATO, or will be initiated by the ATO pre-insolvency. The most commonly initiated ATO actions that fall within the firmer action artillery include issuing garnishee notices, statutory demands, director penalty notices and winding-up notices.[628] Each of these actions will be considered in greater detail in later chapters, including the likely impact of each of these actions on the corporate tax debtor that is either approaching insolvency or that is insolvent.

[626] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 111.
[627] Ibid; TAA 1953 Division 340 of Schedule 1.
[628] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 12; Pricewaterhouse Coopers, *Insolvency Review,* Overarching Report (2013) 5-6. This review was commissioned by the ATO; ATO, PS LA 2011/16, *Insolvency, Collection, Recovery and Enforcement Issues for Entities under External Administration*, para 3.

The Commissioner's Position and the Corporate Insolvency Tax Framework

Returning to the Framework developed earlier in this thesis, an analysis will now be made as to whether the ATO's insolvency debt collection framework achieves the criteria of fiscal adequacy, corporate rescue, equity, efficiency and simplicity.

Fiscal Adequacy

In the context of tax administration and debt collection, the ATO is most concerned about mitigating the risk to the revenue of non-compliance and more broadly, carefully managing its approach to debt collection to contain debt levels at acceptable limits. Delays in collection can affect the level and timeliness of resources available to the government, and on a macro-economic level those delays could add to the level of government borrowing and public debt interest, thereby impacting on the fiscal adequacy criterion.[629] In order to achieve the fiscal adequacy criterion in the context of tax administration, a few themes have emerged in this chapter. These themes include the importance of early intervention, the assessment of business viability, tax debtor engagement with the ATO and of striking the right balance of 'flexible delivery' while fostering a positive compliance culture when administering the tax law.

Early intervention by the ATO is imperative if the fiscal adequacy criterion is to be achieved. The research suggests that penalties and interest can be very effective in preventing and managing debt within the first few weeks after a late payment,

[629] Ireland, Irish Tax Reports, *Collection of Tax Debts, The Collector-General outlines Revenue's Approach* (2008).

however once this period lapses and debt continues to accumulate, penalties and interest become less effective unless they are coupled with some effective form of intervention.[630] Aged debt is also more difficult and more expensive to follow-up.[631] Insolvency practitioners observe that 'without early intervention which will allow a business to take quick action to make it more profitable, the business will likely default in repayments and incur increasing debt to the point of an unsustainable amount, leading to insolvency'.[632] Accordingly, it is sound administrative practise to include early intervention as one of the key objectives within the ATO's insolvency debt management framework. While the framework includes early intervention as a key objective, the private sector has criticised the ATO for being tardy in its debt collection practices and from a practical perspective, there appears to be considerable room for improvement by the ATO in order to be able to achieve this objective.[633] In that regard, there is scope for the ATO to implement a number of additional techniques which target early intervention, such as preventative strategies. Many of these techniques are currently being implemented in a number of jurisdictions and include dynamic risk clustering, the use of predictive data models, preventative interventions, preventative

[630] Elisabeth Poppelwell, Gail Kelly and Xin Wang, 'Intervening to Reduce Risk: Identifying Sanction Thresholds Among SME Tax Debtors' (2012) 10(2) *eJournal of Tax Research* 425.
[631] Aged debt is defined by the ATO as debt outstanding for more than two years. Australian National Audit Office, *The Engagement of External Debt Collection Agencies,* Auditor General Audit Report No.54, Performance Audit (2012) 16; OECD, *Working Smarter in Tax Debt Management* (2014) 30
[632] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 79; Also see Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015) xxi which commented 'Early detection and intervention is crucial to preventing companies in financial distress from either entering insolvency, or continuing to raise debts before eventually collapsing.'
[633] Ibid.

communication and preventative dialogue which are discussed below. As well as achieving increased success rates, preventative strategies have resulted in a change of attitude by the public at large and revenue bodies are now seen as more trustworthy.[634]

Dynamic risk clustering is a technique used by the Canada Revenue Agency which relies upon sophisticated predictive data models to establish a risk score for each tax debtor based on individual taxpayer behaviour.[635] The models can predict whether an outstanding debt will be paid, identify accounts that will 'self-resolve' and the probability that a debt instalment arrangement will be complied with, enabling each debt to be directed to the most appropriate debt management strategy.[636] Classifying each tax debt in this manner results in some cases being subjected to action before a liability becomes due and therefore reduces the rate of debt occurrence.[637]

New Zealand has an early intervention strategy 'Prevent, Assist, Recover & Enforce' for minimising tax debt.[638] This strategy has evolved from 'Debt 2010', a 10 year Debt Collection funding programme which has enabled new focus on early engagement such as preventative type messaging and interventions and 'lighter touch' assistance interventions to customers to achieve compliance.[639] During

[634] Ibid 29.
[635] Canada, Auditor General of Canada, *Report of the Auditor General of Canada,* Report to the Canada Revenue Authority (2013) 92-93, 96-98.
[636] OECD, *Working Smarter in Tax Debt Management* (2014) 28.
[637] Ibid.
[638] Ibid 28, 36 to 37. New Zealand, New Zealand State Services Commission, the Treasury and the Department of the Prime Minister and Cabinet, *Performance improvement framework – Formal review of Inland Revenue* (2011) 28.
[639] OECD, *Working Smarter in Tax Debt Management* (2014) 37.

recent years, additional techniques aimed at early intervention have been introduced including 'Just Pay Now' letters, 40 to 75 day letters, SMS and enforcement rounds (garnishee/deduction notices).[640]

The priority strategy in Sweden is 'preventative' and 'cooperative'.[641] The Swedish Tax Agency (STA) is pro-active in contacting several debtors, by telephone or other means, at the point of a debt arising and offers them information on how to comply with their tax debts.[642] Another success factor is the introduction of the 'payment thinking' within the STA which involves the STA making a strategic decision in relation to a tax debtor at an early stage.[643]

The ATO is becoming increasingly aware of the importance of assessing a business' long term viability at an early stage, however it is not a mandatory part of the ATO's debt collection activities. One possible reform in this area is to revise the ATO's administrative practices so that when a corporate debtor signals cash flow difficulties then pre-emptive action could include a mandatory assessment of business viability at the early intervention stage within the ATO's DMF, rather than making the assessment at a later stage prior to the initiation of legal action, or failing to make any assessment of the business' viability at all. Such a mandatory process would enhance the risk assessment that is currently being undertaken, allowing the ATO to determine its response to the tax debtor. For example, if an

[640] Ibid.
[641] Sweden, Johan Myren and Filippa Andersson, International Association of Young Lawyers, *General communication of tax authorities in friendly or unfriendly ways – Tax commission of coursel National Report of Sweden* (2014) 3.
[642] OECD, *Working Smarter in Tax Debt Management* (2014) 38.
[643] Ibid.

assessment is made that the business is viable in the long-term, an action plan can be developed to assist the business to meet its outstanding tax obligations.[644] However, if the business is considered to be unviable in the long-term the ATO can take appropriate action to mitigate its losses by preventing the business continuing its poor compliance record and escalating its debt. Such firmer action may consist of relying upon one of the legislative instruments in the Commissioner's artillery which will be discussed in the following chapters.

In order to achieve the fiscal adequacy criterion, the ATO must ensure that tax debtors remain engaged in the tax administration process. If the ATO adopts an adversarial approach to regulating businesses, this is likely to result in the taxpayer becoming disengaged. Such a compliance strategy is inappropriately focused and is likely to result in poor regulatory outcomes.[645] Further, if risk management results in an automatic sanction, the tax system is not being regulated in the way that responsive regulation intended because such compliance measures would not be taking into account the circumstances of the taxpayer, which is a key element that underpins the compliance model.[646] Alternatively, if the ATO adopts an approach that fosters flexible delivery with an awareness and understanding of the factors that impact on small business, this is more likely to lead to better regulatory outcomes.[647]

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[644] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 68.
[645] Ibid 65.
[646] Robert Whait, 'Developing Risk Management Strategies in Tax Administration: The Evolution of the Australian Tax Office's Compliance Model' (2012) 10(2) *eJournal of Tax Research* 456.
[647] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 93.

Taxpayer engagement could also be promoted if the ATO adopts more flexible debt relief mechanisms. For example, in the US, the Fresh Start Initiative was introduced in 2012 and expanded in 2014.[648] This initiative was introduced primarily to help individuals and small businesses meet their tax obligations by offering more flexible terms to its Offer in Compromise (OIC) program.[649] In general, an OIC is an agreement between a taxpayer and the Internal Revenue Service (IRS) that settles the taxpayer's tax liabilities for less than the full amount owed.[650] The IRS generally approves an OIC after other payment options have been explored and when the amount offered represents the most it can expect to collect within a reasonable period of time.[651] To apply, the taxpayer (amongst other requirements) must be up to date with all of their filing requirements and not involved in bankruptcy proceedings.[652] This initiative has enabled some of the most financially distressed taxpayers to clear up their tax problems expediently.[653] In mid-2004, the ATO introduced the Small Business Debt Assistance Initiative which was a similar initiative to the US Fresh Start Initiative and the ATO considered this initiative to be a 'productive' initiative.[654] The re-introduction of such an initiative is likely to encourage greater engagement with tax debtors, thereby increasing compliant taxpayer behaviour and assisting in reducing current levels of ATO aged debt.

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[648] US, Internal Revenue Service Advisory Council, *2014 Public Report* (2014) 73-87; US, IRS, *'Struggling with Paying Your Taxes? Let IRS Help You Get a Fresh Start'* available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Struggling-with-Paying-Your-Taxes-Let-IRS-Help-You-Get-a-Fresh-Start on 20 March 2015.
[649] US, Internal Revenue Service Advisory Council, *2014 Public Report* (2014) 73-87.
[650] Ibid.
[651] Ibid.
[652] Ibid.
[653] US, 'Offer in compromise can erase overwhelming tax liability' (1994) 22 *Taxes: The Tax Magazine* 122.
[654] Australian National Audit Office, *The ATO's Administration of Debt Collection—Micro-business*, Auditor General Audit Report No.42, Performance Audit (2006–07) 54-55.

While flexible delivery options are necessary to keep the tax debtor engaged with the ATO, this must be balanced against the ATO taking an approach that is too flexible. If the ATO is perceived to be too flexible in the delivery of its regulation this can adversely affect the fiscal adequacy criterion. In that regard, there is a considerable amount of academic literature which has found that high tax morale, perceived fairness of the tax system, trust in the tax authority and strong social norms, are all important drivers for compliance.[655] A recent OECD report notes that fairness and trust are important drivers for compliance and comments that 'it is not only important what a revenue body does; it is also important how the revenue body does it'.[656] Accordingly, when a taxpayer perceives that others are not paying their fair share, that taxpayer is likely to question why they should pay.[657] Similarly, when a taxpayer withholds tax payments to improve their cash flow and thereby secure an unfair competitive advantage, this can 'push' other businesses to do the

[655] Eva Hofmann, Erik Hoelzl, and Erich Kirchler, 'Preconditions of Voluntary Tax Compliance Knowledge and Evaluation of Taxation, Norms, Fairness, and Motivation to Cooperate' (2008) 216(4) Journal *of Psychology* 209–217; Raymond Fisman and Shang-Jin Wei, 'Tax Rates and Tax Evasion: Evidence from "Missing Imports" in China', (2004) 112 *Journal of Political Economy* 471; Basil Dalamagas, 'A Dynamic Approach to Tax Evasion' (2011) 39 *Public Finance Review* 309, 310; Cynthia Coleman and Lynne Freeman, 'Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance' (1997) 13 *Australian Tax Forum* 311–336; Benno Torgler and Freidrich Schneider, 'The Impact of Tax Morale and Institutional Quality on the Shadow Economy' (2009) 30 *Journal of Economic Psychology* 228–245; Benno Torgler, 'Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments' (2002) 16 *Journal of Economic Surveys* 657–683; Benno Torgler, *'Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis'* (Cheltenham: Edward Elgar, 2007); James Alm and Benno Torgler, 'Culture differences and tax morale in the US and in Europe' (2006) 27 *Journal of Economic Psychology* 224–246; James Alm and Benno Torgler, 'Do ethics matter? Tax compliance and morality' (2011) 101 *Journal of Business Ethics* 635–651. Jeff Pope and Margaret A McKerchar, 'Understanding Tax Morale and Its Effect on Individual Taxpayer Compliance' (2011) 5 *British Tax Review Journal* 587–601.

[656] OECD*, Understanding and Influencing Taxpayers' Compliance Behaviour,* Forum on Tax Administration: Small/Medium (SME) Compliance Subgroup (2010) 30.

[657] Eva Hofmann, Erik Hoelzl, and Erich Kirchler, 'Preconditions of Voluntary Tax Compliance Knowledge and Evaluation of Taxation, Norms, Fairness, and Motivation to Cooperate' (2008) 216(4) *Journal of Psychology* 209–217.

same.[658] Consequently, effective tax administration must involve reducing debt while maintaining the integrity of the tax system.

Corporate Rescue

This chapter has outlined the factors that impact on a small business' ability to comply with tax obligations. Advisors assisting clients in the small business sector recognise that few entrepreneurs achieve instant success, and see their role as being empathetic toward their clients and offering assistance to clients experiencing financial hardship, especially during the establishment and initial growth phase.[659] In a recent Government review, advisors of small business have expressed that small business is vital to the economy, and that the Government needs small business to be profitable, growing and employing people.[660] In particular, the submission provided that the advisors would emphasise 'that the ATO has an important part to play in creating an economic environment where businesses can prosper and that the ATO should avoid making small businesses insolvent and causing additional burdens of unemployment and reliance on government benefits'.[661]

In order to achieve the corporate rescue criterion in the context of tax administration one theme that has emerged in this chapter is the importance of early intervention by the ATO. Such early intervention is likely to be of benefit to

[658] Valarie Braithwaite and Michael Wenzel, *Integrating Explanations Of Tax Evasion And Avoidance, The Cambridge Handbook of Psychology and Economic Behaviour* (Cambridge University Press, 2008) 304-331; Valarie Braithwaite, *Taxing Democracy* (Ashgate Publishing Ltd., 2002).
[659] ICA, *Submission to IGT's Review into the ATO's Approach to Debt Collection* (2014) 3.
[660] IGT, *Debt Collection,* A Report to the Assistant Treasurer (2015) 6.
[661] Ibid.

the corporate tax debtor as without some event to force a business to objectively assess its long term viability, the business is likely to miss opportunities to make the changes needed to remain viable before it is too late.[662] As discussed above in relation to the fiscal adequacy criterion, the assessment of business viability at an early stage is an important part of the early intervention that must occur. If a business is found to be viable in the long-term, the ATO can then enter into better targeted and flexible debt relief arrangements with the tax debtor. Provided that the tax debtor is cooperative and engaged in the tax administration process, then the ATO could offer the tax debtor extended payment arrangements with no up-front payment required, temporarily write off part of their tax debts or possibly even the compromise of outstanding tax debts. The combination of these measures will give corporate tax debtors that are experiencing cash flow difficulties meaningful avenues through which to satisfy their outstanding tax liabilities and remain current and compliant on an ongoing forward basis. Such an approach is more likely to achieve a reduction in the number of taxpayers who might otherwise later be the subject of insolvency action. This approach would balance the need to protect the revenue against the ATO's commitment to giving viable businesses the best possible chance of survival where they may be experiencing short-term difficulties.[663]

[662] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 19, 79.
[663] ATO, Regional Tax Practitioner Working Groups, South East Queensland, *Minutes*, March 2013.

Equity

In order to achieve the 'equity' criterion in the context of tax administration, 'administrative equity' is the goal.[664] In relation to the tax debtor, administrative equity refers to taking into account the taxpayer's circumstances that led to non-compliance. [665] However, in order to appreciate this criterion within the Framework, broader notions of administrative equity must be employed which include how this principle impacts upon all stakeholders including the tax debtor's creditors, other tax debtors and the community.

While it is clear that administrative equity was one of the drivers of the introduction of the ATO's compliance model, this chapter has highlighted that many stakeholder concerns stem from the lack of administrative equity in tax administration. For example, there are concerns that the ATO's administration practices result in inequities as they fail to sufficiently consider the underlying viability of small businesses, that debt collection practices do not uniformly apply the relevant policies and do not deliver fair or proportionate debt collection responses in each case.[666]

The SME market has a large population and the ATO does not have the resources required to take into account many of the qualitative factors of the tax debtor that

[664] Nigel Wilson-Rogers and Dale Pinto, 'Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes' (2009) 7(1) *eJournal of Tax Research* 77. The authors refer state that 'Administrative equity occurs where the administrative procedures that are adopted, in respect of a particular tax, ensure that all taxpayers are treated equally. This would include that all taxpayers had equal access to the information pertaining to their tax affairs'.
[665] Robert B Whait, 'Developing risk management strategies in tax administration: the evolution of the Australian Tax Office's compliance model' (2012) 10(2) *eJournal of Tax Research* 436, 436.
[666] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Report to the Minister for Revenue and the Assistant Treasurer (2005) 10.

the compliance model was based upon. An understanding of the small business debtor's context requires the ATO to know the tax debtor's business-related economic and financial indicators as well as the tax debtor's demographics.[667] This would involve considering the known assets and liabilities of the tax debtor, the age and location of the business, the client focus of the business and the sector or type of business.[668] Additional relevant considerations include identifying the major factors affecting the industry in which the business is operating, the extent to which trends might highlight issues relevant to the taxpayer's ongoing viability, movements of accounts and solvency indicators and external events such as restrictive policies by financial institutions.[669] This assessment is critical for the ATO to be able to assess small business debtors who 'want to comply but are unable to do so in the short-term; debtors who are incapable of complying (probably ever); and those debtors who are unwilling to comply'.[670] This assessment is required for the ATO to apply the most appropriate treatment to each type of compliance behaviour, thereby balancing the interests of all stakeholders.[671] Such an administrative process is also consistent with the OECD's recommendation that the tax debt collection function needs to be able to choose from a 'rich suite of interventions, ranging from soft measures, designed to prevent people from falling into debt in the first place, through to tough enforcement measures.'[672]

[667] IGT, *'Debt Collection, A Report to the Assistant Treasurer'* (2015) 39-40.
[668] ATO, Regional Tax Practitioner Working Groups, South East Queensland, *Minutes*, March 2013, 31.
[669] Ibid.
[670] Australian National Audit Office, *The ATO's Administration of Debt Collection—Micro-business*, Auditor General Audit Report No.42, Performance Audit (2006–07) 42.
[671] Ibid.
[672] OECD, *Working Smarter in Tax Debt Management* (2014) 15.

While the ATO has introduced advanced risk analysis in combination with behavioural insights to assist in the risk assessment, the considerable stakeholder concerns indicate that the ATO is failing to capture a considerable amount of this qualitative information about the tax debtor when making its assessment, leading to poor regulatory interventions and outcomes. Accordingly, one method of being able to address these stakeholder concerns is to develop tools or processes which are focused on capturing the qualitative factors of the tax debtor. While the compliance model was developed to facilitate administrative equity, it is also a risk management tool developed to help improve administrative efficiency. Encapsulating all of this qualitative information of a tax debtor comes at a cost to administrative efficiency. In that regard, just as the traditional economic concepts of equity and efficiency are in conflict, so too may administrative efficiency conflict with administrative equity. Accordingly, the ATO must monitor these two competing criteria, because the community may perceive the system of tax administration to be unfair if achieving efficiency in tax administration is prioritised over achieving equity, which would adversely impact upon the voluntary compliance regime and undermine the integrity of the tax system.

Looking at the concept of equity more broadly, stakeholders have also criticised the ATO for not appropriately balancing the competing interests of the major stakeholders involved including the debtor, other creditors and the ATO.[673] In this regard, the ATO has been criticised for being too flexible in its debt collection

[673] Lisa Marriott notes its effect on the 'goodwill of compliant taxpayers' in Lisa Marriott, 'Tax debt management in New Zealand and Australia' (2014) 9 *Journal of Australasian Tax Teachers Association* 1.

practices.[674] If the ATO is too flexible in its intervention, then other creditors of the debtor's business may perceive that business to be viable on the basis that the ATO is agreeing to payment arrangements.[675] The ATO has better information available about the debtor's financial condition than general unsecured creditors.[676] For example, the ATO has access to information concerning the tax debtor's behaviour such as lodgement performance, income information and tax payments, personal details and financial information and details of the ATO's interactions, including compliance activities in relation to that tax debtor's debt management.[677] This information is not available to the general unsecured creditors of the tax debtor.[678] Privy to this information, the Commissioner is in a position where he is able to identify debtor default immediately, predict the likelihood of further debtor default and make a more accurate assessment of insolvency risk.[679] Allowing tax debts to accumulate under those circumstances can unfairly disadvantage other unsecured creditors and in some instances, secured creditors who go on trading with the debtor not knowing that there is a tax default. In order to address this current failing of the ATO, policies focused upon early intervention by the ATO and early assessment of business viability before such flexible arrangements are entered is of paramount importance to the protection of general business creditors and the community. From a public interest perspective and to maintain the integrity of the

[674] Lisa Marriott, 'Tax debt management in New Zealand and Australia' (2014) 9 *Journal of Australasian Tax Teachers Association* 1.
[675] Ibid.
[676] See IGT, *Debt Collection, A Report to the Assistant Treasurer* (2015) 7, 99, 139.; The ATO keeps a Running Balance Account for each taxpayer and records all interactions with a taxpayer in respect of tax debts. The ATO also keeps personal data including contact and address details of each taxpayer.
[677] Ibid.
[678] Ibid.
[679] Ibid.

tax system, it is important for the ATO to be able to distinguish a business that is viable but is experiencing short-difficulties from a business that is no longer sustainable over the long term as early as possible within the debt collection framework.

Efficiency

In order to achieve the 'efficiency' criterion in the context of tax administration, 'administrative efficiency' is the goal. In the context of the ATO's debt collection practices, administrative efficiency refers to the cost-effectiveness of the ATO in targeting non-compliant tax debtors and recovering outstanding debt whilst maintaining neutrality.[680] As discussed in this chapter, in order to channel the ATO's resources into those areas that present the greatest compliance risk, the ATO utilises an ERMF to make assessments and manage all 'enterprise risks'.[681] This chapter has considered how administrative efficiency has improved as a result of the ATO implementing an approach that focuses on the debtor instead of the debt and makes use of modern techniques such as advanced analytics and behavioural sciences to understand the drivers of tax debtor behaviour. These modern techniques make it possible to 'more effectively prioritise debts, to better allocate resources and to achieve greater consistency'.[682] The ATO can continue to gain greater efficiency in its debt collection function by implementing a number of additional techniques which target early intervention. The preventative strategies

[680] Annette Morgan, 'Institutional Framework of Taxation in Australia', *ConTax* (May 2013).
[681] IGT, *Review into aspects of the ATO's use of compliance risk assessment tools*, Report to the Assistant Treasurer (2013) 6.
[682] UK, Michael Hallsworth, John List, Robert Metcalfe, and Ivo Vlaev, *The Behavioralist As Tax Collector: Using Natural Field Experiments to Enhance Tax Compliance*, National Bureau of Economic Research (NBER) Working Paper Series, NBER Working Paper No. 20007 (2014).

that are currently employed in other jurisdictions were discussed in relation to the fiscal adequacy criterion. An additional strategy could be to introduce strategies that achieve greater integrated compliance. Further, more research must be conducted to determine the effectiveness of third party debt collectors as there is little evidence to date which shows that the ATO's ECDAs create efficiencies in tax administration. These additional strategies are discussed below.

Australia's tax system is based upon the premise that transactions are reported after they have occurred by taxpayers themselves which means that tax reporting occurs after taxable income has been calculated by the taxpayer.[683] As such, reporting can take place many months subsequent to a transaction having been completed. Accordingly, the Australian tax system fails to integrate tax compliance as a natural part of taxpayers' business process.[684] A recent OECD report emphasised the importance of integrated compliance to efficient tax administration. The report stated:[685]

> The more tax administrations succeed in making taxpayers pay as they earn, the smaller the debt book will be. Tax administrators need to make tax payment part of the normal system of doing business and as close to the event creating the liability as possible, in order to eliminate or reduce the risk of non or late payment.
>
> …Tax compliance by design in debt management means that taxes should be levied as close to real time preferably based on lead indicators instead of lag indicators, such as income and tax declarations that are prepared in arrears and submitted annually.

In order for the ATO to achieve greater administrative efficiency, legislation must be enacted which integrates compliance into the taxpayer's business in the manner

[683] Taxpayers Australia Inc., *Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014) 2.
[684] Ibid.
[685] OECD, *Working Smarter in Tax Debt Management* (2014) 18.

described above. One possibility for achieving integrated compliance is by making greater use of third party withholding and reporting. Third party withholding and reporting refers to 'a mandatory requirement on prescribed third parties (e.g. businesses, financial institutions, and government agencies) to' withhold an amount of tax from payments of income to taxpayers and 'report payments of income (and other tax-related transactions) and payee details (generally with a taxpayer identifying number) to the revenue body.'[686]

The implication of third party reporting and withholding is that tax debts never accrue in the first place. Instead, as soon as a transaction is undertaken, the payer of the source of income remits tax to the tax authority, with the net amount paid to the taxpayer. Published research findings of the STA, HMRC and the IRS clearly indicate that there are significant compliance-related benefits from the use of withholding.[687] Furthermore, the timely remittance of amounts withheld by payers to the revenue body ensures a consistent revenue stream to Government accounts, thereby providing fiscal adequacy and budgetary gains.[688]

In comparison with the tax systems of most OECD countries, Australia's income tax system makes relatively limited use of both withholding and reporting mechanisms.[689] For example, in the UK, all bank interest is paid to taxpayers with a component of income tax already deducted.[690] Payments of wages and salaries

[686] Ibid 304.
[687] OECD, *Tax Administration 2013, Comparative Information on OECD and other Advanced and Emerging Economies* (2013) 289.
[688] Ibid.
[689] Ibid 296-297.
[690] See UK, HMRC, *Income Tax: Personal Savings Allowance update,* Policy Paper (2016); 'Basic rate' taxpayers receive up to £1,000 and 'higher rate' taxpayers up to £500 pounds before this occurs.

are made to employees net of tax and with a sophisticated system of Pay as You Go (PAYG) coding, the amount which is withheld is extremely accurate and equates almost precisely to the amount of tax due.[691] Withholding and mandatory reporting arrangements are also used to varying degrees in many countries for payments made by businesses to certain categories of taxpayers ranging from the self-employed and SMEs and to other types of receipts including rents, royalties and patents and sales of shares and real property.[692]

Two initiatives that have been introduced by the ATO to integrate tax compliance include Standard Business Reporting (SBR) and Single Touch Payroll.[693] The ATO is moving towards SBR and contemporaneous data collection as key driver in the way in which it interacts with business taxpayers.[694] SBR allows taxpayers to lodge forms directly from their business accounting or payroll software.[695] The ATO believes that SBR offers greater efficiency, accuracy and certainty to the taxpayer.[696] Under this electronic payroll system, employers will be required to electronically report payroll and super information to the ATO when employees are paid, using SBR-enabled software.[697] The ATO will conduct a pilot of Single Touch Payroll reporting

[691] Ibid 290, 293, 296-297.
[692] Ibid 274.
[693] Kelly O'Dwyer, Minister for Small Business, Assistant Treasurer, *Streamlining business reporting with a single touch payroll* (Media Release, 21 December 2015); Arthur Athanasiou, '2016: a year of disruption and transition to digital communication' (2016) 50(7) *Taxation in Australia* 362.
[694] Thilini Wickramasuriya, 'New tools of the trade' (2016) 50(7) *Taxation in Australia* 365.
[695] Michael Flynn, 'Proposed changes to IT systems and project do it' (2014) *Taxation in Australia* 2.
[696] ATO, *SBR* available at https://www.ato.gov.au/General/Wealthy-individuals/In-detail/Compliance-information/Tax-compliance-for-small-to-medium-enterprises-and-wealthy-individuals/ on 20 March 2015.
[697] Ibid.

in the first half of 2017.[698] From 1 July 2017 Single Touch Payroll reporting will be available to all businesses.[699] From 1 July 2018, employers with 20 or more employees will be required to use Single Touch Payroll reporting when reporting to the ATO.[700] Once the pilot is completed, the Government will determine a timeframe in which to roll out Single Touch Payroll for those businesses with less than 20 employees.[701] As employers will be required to remit PAYG withholding and the Superannuation Guarantee using their software at the same time that employees are paid, this will achieve greater integrated compliance. The development of new technology and new strategies creates more opportunities for integrated compliance resulting in taxpayers paying taxes in real-time, paying directly as they earn and paying per transaction. These two initiatives may be the catalyst needed to stimulate greater innovation in this area.

One further possibility for achieving better integration is that the GST could be collected at point of sale through the banking system.[702] Such a system would ensure that levels of tax debt are minimised, resulting in efficiency savings from the

[698] ATO, *Single Touch Payroll Discussion Paper, Consultation Process* (2015); ICA, *Submission to the ATO's Single Touch Payroll Discussion Paper* (2015).
[699] Kelly O'Dwyer, Minister for Small Business, Assistant Treasurer, *Streamlining Business Reporting With A Single Touch Payroll*, Media Release, 21 December 2015 available at http://kmo.ministers.treasury.gov.au/media-release/042-2015/ on 6 April 2016; ATO, Regulation Impact Statement, *Single Touch Payroll* (2016).
[700] Ibid.
[701] Ibid.
[702] OECD, *Tax Compliance by Design: Achieving Improved SME Tax Compliance by Adopting a System Perspective* (2014) 58. A number of examples are provided including the Electronic VAT invoicing system which has been implemented by the Chilean Internal Revenue Service.

flow-on effect of the revenue authority not having to maintain such an intensive focus on debt collection.[703]

There is little evidence to indicate that the ATO's use of EDCAs is efficient. In 2012, the Australian National Audit Office conducted an audit to assess the effectiveness of the ATO's administration of external debt collection arrangements.[704] The results of the audit were generally positive and it was concluded that 'the agencies provide the ATO with a flexible mechanism to action a workload that would otherwise remain unactioned'.[705] The audit found that in approximately 50 per cent of the referred cases, EDCAs achieved either payment in full, or negotiated payment arrangements with taxpayers.[706] The report also stated that the EDCAs 'have collected a significant amount of debt, generating very few taxpayer complaints and there have been no known breaches in the security of taxpayers' data.'[707] Clearly, since the time of publication of that report, tax debtor sentiment has changed considerably with the IGT commenting that a 'major source of dissatisfaction for stakeholders was the ATO's use of EDCAs.'[708]

The audit report recommended that 'The ATO could more effectively analyse and evaluate the costs of the program, and consider efficiencies that could be achieved, including the targeting of debt cases for referral. Such an analysis would also assist

[703] Ibid.
[704] Australian National Audit Office, *The Engagement of External Debt Collection Agencies,* Auditor General Audit Report No.54, Performance Audit (2012).
[705] Ibid 16.
[706] Ibid.
[707] Ibid.
[708] IGT, *Review into the ATO's Approach to Debt Collection* (2014) Terms of Reference and Submission Guidelines.

the ATO in more clearly outlining the ATO's future use of the outsourcing arrangement. In undertaking this work, it may be useful for the ATO to consider the different experiences of revenue and taxation offices internationally, including the UK, the US, and Canada.' [709]

In the international context, experiences of outsourcing tax debt collection to private entities vary among revenue bodies.[710] Whilst third party debt collection has achieved some success in Australia, this is in contrast to attempts by other countries to outsource tax debt collection, which have concluded that it is uneconomic and proceeded to collect debts using internal debt collection departments. [711] For example, in the US, the IRS introduced a Private Debt Collection Program which continued for nearly three years before the IRS ended it.[712] There are a number of studies that found that the IRS was more effective than the ECDAs in collecting tax debts.[713] Accordingly, it is evident that when a revenue authority outsources its debt collection function, that this will not automatically result in efficiency gains and that continued monitoring and evaluation of the EDCA is imperative. At this stage, even though there have been mixed reports, it appears as though the ATO will continue to outsource part of its debt collection function to EDCAs.[714] However, there are likely to be changes to the way in which EDCA's

[709] Australian National Audit Office, *The Engagement of External Debt Collection Agencies,* Auditor General Audit Report No.54, Performance Audit (2012) 109.
[710] OECD, *Working Smarter in Tax Debt Management* (2014) 79.
[711] Ibid.
[712] Ibid.
[713] US, Electronic Tax Administration Advisory Committee, *Annual Report to Congress* (2013) Section 6; United States of America, Internal Revenue Service, *IRS Private Debt Collection, IRS Cost Effectiveness Study* (2009); US, Government Accountability Office, *Tax Debt Collection, IRS Could Improve Future Studies by Establishing Appropriate Guidance*, Report to the Ranking Member, Committee on Finance, U.S. Senate (2010).
[714] IGT, *'Debt Collection, A Report to the Assistant Treasurer'* (2015) 143.

engage with tax debtors as a result of the new 'Debt Collection Guidelines: For Collectors and Creditors' which were released jointly by the Australian Securities and Investments Commission (ASIC) and the Australian Competition and Consumer Commission on 8 July 2014 (Guidelines). The ATO will need to ensure that appropriate policies and procedures are in place to secure compliance with the Guidelines by EDCAs. Failure to comply with these Guidelines may result in considerable pecuniary penalties for the ATO, including maximum fines of up to $1,800,000 per offence.[715]

Simplicity

This chapter has discussed a number of strategies that the ATO has introduced to streamline and simplify processes for the business taxpayer. These include service-driven strategies that are aimed at improving communication and the online customer service experience and tools that allow for easy payment, support viable businesses and reduce costs for taxpayers.

It is likely that there will be considerable investment in developing online resources to further improve ATO online service delivery.[716] The private sector has submitted that an improved online service could build upon the current tax portal by introducing tailored tools for each taxpayer, rather than providing generic

[715] *Australian Securities and Investments Commission Act 2001* (Cth) s12GBA(3); *Crimes Act 1914* (Cth) s 4AA.

[716] Geoff Leeper, Second Commissioner, People, Systems and Services, *Tax Administration Transformation: Reinventing the ATO*, Address to the National Tax Practitioner Conference Sydney, Wednesday, 18 June 2014 (Delivered by First Assistant Commissioner Steve Hamilton on behalf of Second Commissioner Geoff Leeper) available at https://www.ato.gov.au/Media-centre/Speeches/Other/Tax-administration-transformation--Reinventing-the-ATO/ at 15 July 2016; ATO, *ATO Capability Action Plan Update* (2014).

information.[717] The ICA have submitted that such tools might include personalised tax payment calendars, payment reminders and offers of ATO assistance to small business taxpayers, particularly during the establishment phase of a business.[718] Further, the ICA has submitted the online portal must be better equipped for external service providers such as the business' accountant who should be privy to the information the ATO provides their clients, including real-time information access and 'warnings signals'.[719] This information would assist these professionals who are likely to have a better understanding of their client's business and personal circumstances to intervene in their client's affairs at an early stage, which may involve assisting their client to develop a business plan or to negotiate a debt relief option with the ATO.[720]

In the US, a number of recommendations were made to the IRS by the Electronic Tax Administration Advisory Committee (ETAAC) in its June 2014 Annual Report to Congress. The Report made the following comment in relation to the online experience that the IRS should be aiming towards '[l]argescale financial institutions and retailers, as well as many other industry sectors, provide customers with a comprehensive, personalized online experience to manage their accounts, make transactions, and interact without ever visiting an office or store. Technology also enables online providers to tailor the customer experience to the customer's profile, buying habits and prior interests – all of which provide a highly engaging,

[717] ICA, *Submission to the IGT's Review into the ATO's Approach to Debt Collection* (2014) 5.
[718] Ibid 6.
[719] Ibid 5.
[720] Ibid.

effective service delivery model.' [721] To achieve high taxpayer adoption and satisfaction, ETAAC believes that the IRS should provide taxpayers with a comprehensive, customised online experience, at the same standard expected of today's retailers and financial service providers.

This recommendation translates well into the experience that the ATO should be aiming to provide its 'customers'. Further, if the online experience is vastly improved, it is likely that this will also result in increased tax debtor engagement, greater efficiencies and increased voluntary compliance with the tax system.

Conclusion

This chapter has considered the ATO's insolvency debt collection framework. In the context of a tax debtor approaching insolvency or that is insolvent, it is evident that the manner in which the ATO administers the tax law has the potential to impact a number of stakeholders. An analysis of the criteria within the Framework has provided useful insights in relation to where weaknesses in the ATO's insolvency debt collection administrative function lie. In that regard, in order to achieve the fiscal adequacy criterion within the Framework, containing debt levels at reasonable levels is imperative and strategies aimed at reducing levels of collectable debt, particularly those aimed at early intervention, is one area for future action. Further, early intervention, including the assessment of a business' viability at an early stage is an also an important driver in being able to achieve the other criteria within the Framework.

[721] US, Electronic Tax Administration Advisory Committee, *Annual Report to Congress* (2014) 25.

Other strategies that the ATO should focus on which will result in the criteria in the Framework being achieved, include adopting more flexible debt relief mechanisms in certain cases, capturing more qualitative information about the tax debtor, integrating tax compliance as a natural part of taxpayers' business processes and developing online resources to further improve ATO online service delivery. The development of new technology and new strategies creates more opportunities for more effective tax administration.

The next three chapters of this thesis will expand upon this chapter by considering the second element of the ATO's insolvency debt collection framework, 'firmer action', in greater depth. In particular, these chapters will explore three of the most powerful ATO debt collection tools within Australia's current tax regime, namely the power to serve:

- a section 260–5 notice under Schedule 1 of the TAA 1953 (Chapter 6);
- director penalty notices under Division 269 to Schedule 1 of the TAA 1953 (DPNs) (Chapter 7);
- statutory demand notices under section 459E of the Corporations Act (Chapter 8).

These chapters will focus on how these legislative instruments under the TAA 1953 and the Corporations Act impact upon a corporate tax debtor that is approaching insolvency or that is insolvent as well as consider the impact of these instruments on other stakeholders in a corporate insolvency. An assessment will be made as to whether these powers of the Commissioner in the TAA 1953 and the Corporations

Act are effective in the context of corporate insolvency, by applying the Framework. A further theme that will be explored is whether achieving the fiscal adequacy criterion comes at the peril of achieving successful corporate rescue post insolvency.

Chapter 6 - Recourse Against the Insolvent Company: The Commissioner's Power to Issue Garnishee Notices

Introduction

The previous chapter considered the ATO's debt collection framework, including a number of debt collection strategies that the ATO has developed. This chapter expands on that discussion by considering the second element of the ATO's debt collection framework in greater depth, being the ATO's focus on firmer action. There are a number of powers available to the Commissioner if he wishes to take 'firmer action'.

One of the most effective debt collection powers within Australia's current regime is the Commissioner's power to issue a notice to a third party that owes money to or holds money for a tax debtor under section 260-5 of Schedule 1 to the TAA 1953 (section 260-5). This chapter will discuss how an insolvent corporate tax debtor is likely to be impacted as a result of the use of this power by the Commissioner. The Framework will be applied to assess the effectiveness of this power of the Commissioner in the context of corporate insolvency. In particular, it will be argued that the issue of a section 260-5 notice has regrettable consequences when it comes to attempts to implement corporate rescue. This results in considerable disharmony at the intersection of tax law and insolvency law. The chapter suggests areas for reform and considers directions for future research and action.

The Issue of a 'Garnishee' Notice

Where a person (third party) owes money to or holds money for a tax debtor, section 260-5 empowers the Commissioner to require the third party to pay that money to the Commissioner rather than paying it to, or continuing to hold it for, the tax debtor. Those notices are the same notices that were previously able to be issued under section 218 of the ITAA 1936.[722]

When these notices are issued, they create a 'statutory charge' in favour of the Commissioner which is why they have been compared to a form of garnishee order, notwithstanding the absence of judicial intervention.[723] The Commissioner's power to issue these notices is commonly referred to as a 'garnishee power' and a written notice issued by the Commissioner under subsection 260-5(2) is referred to as a 'garnishee notice'. Any third party who pays money to the Commissioner as required by a notice is taken to have been authorised by the tax debtor or any other person who is entitled to all or part of the amount prescribed by the notice. The third party is indemnified for any money paid to the Commissioner.[724]

The ATO practice is that where subsequent to the issue of a garnishee notice, the tax debtor is subject to external administration, the Commissioner will not

[722] Section 260-5 of Sch 1 to the TAA 1953 was inserted into the TAA 1953 by amendments made to that Act by the *A New Tax System (Tax Administration) Act 1999* (Cth).
[723] In *FJ Bloemen Pty Ltd v FCT* [1981] HCA 27, Mason and Wilson JJ spoke of 'the garnishee power in s 218', and in *Clyne v DCT* (1982) 56 ALJR 857, Mason J remarked upon the 'quite striking' similarity between s 218 and the rules of court respecting garnishee orders. More recently in *Bluebottle UK Ltd v DCT* [2007] HCA 54 the Court described s 218 of the ITAA 1936 as containing 'statutory garnishee provisions'.
[724] TAA 1953 s 260-15.

ordinarily withdraw that notice.[725] In that regard, the notice will continue to operate on the relevant amounts.[726] Where it is apparent that the tax debtor is about to enter or become subject to external administration, the Commissioner will only issue a garnishee notice in respect of amounts due (or expected to become due), after having regard to a number of factors.[727] These factors include the need to protect the revenue and the expected impact that the garnishee will have on the tax debtor's unrelated, arm's-length creditors, in terms of their likely receipts from the tax debtor's insolvency administration.[728]

The high-profile decision in *Queensland Maintenance Services Pty Ltd v FCT*[729] coupled with a number of other decisions have made it clear that the Commissioner is relying upon these notices as a way of obtaining an advantage in corporate insolvencies.[730] The Commissioner is able to garnish credit card merchant facilities, purchase monies advanced under a mortgage of land or other property, financial institution accounts, trust funds and shares, at any time prior to a company entering into external administration. Further, if large corporate groups are involved in insolvency proceedings, the Commissioner can potentially issue the notices to a number of solvent members of a corporate group in relation to the insolvent member's tax debt.[731]

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[725] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 124.
[726] Ibid.
[727] Ibid, para 125.
[728] Ibid.
[729] [2012] FCAFC 152.
[730] *Re Octaviar Ltd (No 8)* [2009] QSC 202; *Bruton Holdings Pty Ltd v Commissioner of Taxation* [2009] HCA 32.
[731] Jason Harris and Anil Hargovan, 'Corporate Groups: The Intersection between Corporate and Tax Law: Commissioner of Taxation v BHP Billiton Finance Ltd' (2010) 32 Sydney Law Review 723;

There is now a substantial body of decided cases that concern the validity of these notices. While the majority of those cases concern notices served under the predecessor of section 260-5, being section 218 of the ITAA 1936, the wording of the new legislation is similar to the old legislation and the Explanatory Memorandum published in relation to section 260-5 makes it clear that it is intended to have the same meaning and effect as its predecessor.[732] Accordingly, the older cases which consider the validity of notices issued under section 218 of the ITAA 1936 continue to be relevant. The power conferred on the Commissioner by section 260-5 and section 218 has been described by the judiciary as 'extraordinary'.[733]

The Validity of the Notices: 'Statutory charge' but not a 'Proprietary charge'

One of the leading authorities on the validity of notices served by the Commissioner is the Federal Court's decision in *FCT v Donnelly*.[734] In that case, the Court had to consider the nature of the Commissioner's power which resulted from a section 218 notice, in order to determine whether the Commissioner was a 'secured creditor' for the purposes of section 58(5) of the *Bankruptcy Act 1966* (Cth). The term 'secured creditor' was defined to include a person holding 'a mortgage, charge or lien on property of the debtor' as security for a debt due to him or her from the

Jason Harris, 'Corporate group insolvencies: Charting the past, present and future of pooling arrangements' (2007) 15 *Insolvency Law Journal* 78.

[732] Explanatory Memorandum to the *A New Tax System (Tax Administration) Bill 1999* (Cth) 50-60.

[733] *Edelsten v Wilcox* (1988) 19 ATR 1370 at 1384.

[734] (1989) 25 FCR 432.

debtor. Justices Hill and Lockhart compared the effect of a section 218 notice with garnishee proceedings.[735] Hill J said that there was a striking similarity between the two, which was influential to His Honour's conclusion that the Commissioner was a secured creditor.[736] Hill J reasoned as follows: [737]

> A notice under section 218 is not itself a garnishee order although as Mason J in Clyne's case remarked it is certainly very similar to such an order. Particularly, in my view it confers upon the Commissioner not merely the negative right to prevent the taxpayer from accepting payment of the debt or disposing of it, but positive rights, namely a right to give a valid receipt and discharge for the money (section 218(4)): the payment being deemed by that section to have been made under the authority of the taxpayer and there is conferred upon the Commissioner the further right in the event of default or failure to comply with a section 218 notice to apply to the court for an order requiring the convicted person to pay to the Commissioner an amount which the convicted person has refused or failed to pay. Thus the similarity between the section 218 notice and garnishee order is indeed most striking and in my opinion it follows that for the purposes of the Bankruptcy Act 1966 (Cth) there is created in the Commissioner by virtue of the service of the section 218 notice a charge so that the Commissioner becomes for the purposes of bankruptcy law a secured creditor.

In the Full Court of the Federal Court's decision in *Macquarie Health Corporation Ltd v FCT*,[738] the liquidator argued that a section 218 notice was equivalent to a garnishee order, which was said to 'not necessarily suggest that section 218 creates a charge, since a garnishee order does not affect an assignment of the property of the garnishee.'[739] Accordingly, the liquidator argued that the majority decision in *Donnelly* was wrong and should not be followed. The Court did not accept the

[735] *FCT v Donnelly* (1989) 25 FCR 432 at 435; Hill J and Lockhart J referred to a series of single judge decisions that compared a s218 notice with garnishee proceedings, including a decision of Carter J in *Tricontinental Corporation Ltd v FCT* [1988] 1 Qld R 474.
[736] Ibid 456.
[737] Ibid; See also *Commissioner of Taxation v Barnes Development Pty Ltd* [2009] FCA 830.
[738] (1999) 96 FCR 238.
[739] Ibid 78.

liquidator's arguments.[740] Justices Hill, Sackville and Finn summarised the effect of notices issued under section 218 of the ITAA 1936 as follows: [741]

> Once it is accepted that Donnelly should be followed, subject to further arguments as to the effect of the taxpayer's winding up, certain conclusions follow:
>
> (i) The service of the section 218 notices on the debtors created an interest in the nature of a statutory charge over any debts then due by the debtors to the taxpayer. The charge was created notwithstanding that the amounts due to the taxpayer were not payable until a future date.
>
> (ii) The notices were also effective to create a statutory charge over any debts coming into existence (whether or not payable immediately) after the date of service, but before commencement of the winding up.
>
> (iii) To the extent the Commissioner was entitled to a statutory charge over debts due by the debtors to the taxpayer, s 471C of the Corporations Law preserves the Commissioner's right to realise or enforce the charge notwithstanding the winding up of the taxpayer.
>
> (iv) The liquidator cannot invoice s 474(1) of the Corporations Law to take control of debts subject to the statutory charge in favour of the Commissioner.

One of the questions the Court had to answer in *Macquarie Health Corporation* was whether the Commissioner was a 'secured creditor' under section 471C of the Corporations Act. Section 471B of the Corporations Act provides that while a company is being wound up in insolvency or by the court (or by a provisional liquidator), a person cannot begin or continue with a proceeding against the company, or a proceeding or enforcement process in relation to its property. That is qualified by s 471C of the Corporations Act which provides that nothing in section 471B (or section 471A) of the Corporations Act affects a secured creditor's right to realise or otherwise deal with the security. The Full Court held that just as the service of a section 218 notice made the Commissioner entitled to a security for

[740] Ibid 79.
[741] Ibid 80.

the purposes of the bankruptcy law in *Donnelly*, so it made him a secured creditor for the purposes of section 471C of the Corporations Act.

In *Bruton Holdings Pty Ltd (In Liq) v FCT*,[742] the High Court of Australia (HCA) said that a notice under section 260-5 operates in the manner in which a garnishee order attaches to a debt. The Court applied this passage from the judgment of Kitto J in *Hall v Richards*:[743]

> Such an order, though not working an assignment or giving the judgment creditor any proprietary interest in the debt, yet gives him positive rights with respect to it which a creditor having no more than a judgment does not possess; not merely a negative right to prevent the judgment debtor from accepting payment of the debt or disposing of it, but positive rights for the recovery of what is owing on the judgment, namely a right to give a valid receipt and discharge for the money, and a right in case of non-payment to obtain execution against the garnishee.

In Bruton Holdings, the HCA did not disapprove of the judgments in *Donnelly* and *Macquarie Health Corporation*.

One case concerning the effect of a garnishee notice is *Hansen Yuncken Pty Ltd v Ericson*, [744] which considered the payment into Court of funds to which the Commissioner claimed an entitlement and in circumstances where priority was the subject of competing claims by other creditors. The Commissioner's application to the Supreme Court for payment of the monies out of Court was unsuccessful. The Commissioner filed an appeal to the Queensland Court of Appeal from the Supreme Court decision, which was subsequently dismissed by consent. McMurdo J held:[745]

> Although the Commissioner was for some purposes the holder of a statutory charge over what was to be paid by Hansen Yuncken to Mr Ericson, that was not… a "proprietary charge." It conferred no proprietary interest in that debt. Consequently,

[742] [2009] HCA 32.
[743] [1961] HCA 34; [2009] HCA 32 at 14.
[744] [2012] QSC 51.
[745] Ibid [37]-[38].

> when that debt was extinguished, the Commissioner could claim no proprietary entitlement to what was paid to extinguish that debt, that is, the moneys now in court…..
>
> ….the consequence of those payments was that Hansen Yuncken was completely discharged. It was no longer a person who owed, or might owe, money to Mr Ericson because he was then unconditionally and permanently restrained from enforcing the adjudication decision.

The Commissioner continues to dispute His Honour's view that the payment of monies into court subject to a garnishee notice extinguishes the obligation of the recipient of the notice to comply.[746] To this end the ATO has published a Decision Impact Statement in relation to this case.[747] The ATO's view is that this decision is inconsistent with the earlier authorities of *FCT v Government Insurance Office of New South Wales*[748] and *Macquarie Health Corporation*.[749] The Commissioner proposes to raise this issue in future cases to seek clarity on any conflicting authorities.[750] However, even if this judgement is upheld on appeal, the Commissioner appears to have independent rights to bring action in debt against the notice recipient for incorrectly paying amounts into court rather than in accordance with the statutory obligation in section 260-5.[751] The Commissioner states that recourse in this manner is a 'reasonably open consequence'.[752]

Accordingly, based on the number of authorities which have considered the validity of garnishee notices, it is clear that the service of a third-party notice pursuant to section 260-5 creates a statutory charge in favour of the Commissioner and hence

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[746] ATO, Decision Impact Statement, *Hansen Yuncken Pty Ltd v Ericson t/as Flea's Concreting*, issued 25 February 2013.
[747] Ibid.
[748] (1992) 36 FCR 314.
[749] (1999) 96 FCR 238.
[750] See *Commissioner of Taxation v Barnes Development Pty Ltd* [2009] FCA 830
[751] Ibid.
[752] ATO, Decision Impact Statement, *Hansen Yuncken Pty Ltd v Ericson t/as Flea's Concreting*, issued 25 February 2013.

makes the Commissioner a secured creditor in a company liquidation. While there may be limitations on the nature of the charge which is created by the service of a garnishee notice, it is clear that the statutory charge created is sufficient to be able to gain an advantage over ordinary unsecured creditors in a corporate insolvency, and hence in practical terms can be considered a *de facto* priority in favour of the Commissioner. Consideration will now be given to the priority between section 260-5 notices and creditors with general law fixed interests and *Personal Property Securities Act 2009* (Cth) (PPSA) security interests.

Garnishee Notices Served on Creditors with General Law Fixed Interests and PPSA Security Interests

Interaction with General Law Fixed Interests

There is clear authority that a fixed charge over a debt takes priority over a section 260-5 notice issued in relation to a debt.[753] However, one case provides an alarming example of a situation where the Commissioner has been able to exercise his power to issue a garnishee notice in priority to an existing fixed charge over a debt. In the circumstances of *Deputy Commissioner of Taxation* (DCT) v *Park*,[754] the taxpayer owned a property subject to a mortgage securing a debt due by her to the mortgagee. She entered into a contract to sell the property. Prior to settlement of the contract, the Commissioner served a notice under section 260-5 on the purchasers to pay to the Commissioner a sum equivalent to the taxpayer's tax debt

[753] *Elric Pty Ltd v Taylor* (1988) 19 ATR 1551; *Zuks v Jackson McDonald (a firm)* (1996) 33 ATR 40; *Public Trustee (Qld) v Octaviar Ltd* [2009] QSC 202; *Markets Nominees Pty Ltd v FCT* [2012] FCA 262.
[754] [2012] FCAFC 122.

immediately after the purchase monies became owing to the taxpayer. The contract did not settle as was agreed because, in light of the section 260-5 notice, the purchaser was unwilling to provide a cheque in favour of the mortgagee in the full amount sought by the mortgagee and the mortgagee was not prepared to release its legal charge under the mortgage.

The standoff was resolved by the Commissioner, whilst reserving his rights, agreeing to the full amount sought by the mortgagee being paid into its solicitor's trust account without deduction at settlement, and the solicitor agreeing not to release the amount comprising the disputed funds, without the Commissioner's consent. On this basis, the mortgagee released its legal charge under the mortgage, and settlement occurred. The Federal Court held that the section 260-5 notice was effective for the Commissioner to take priority over a secured creditor in relation to proceeds of the sale of secured property. By releasing its mortgage over the property, the mortgagee compromised its position. Although the Commissioner consented to settlement proceeding under arrangements which included that release, he made it clear in correspondence that his consent was not to be interpreted as surrender of his claim under section 260-5.

In this instance, the purchaser's obligation in relation to a garnishee superseded the obligation or discretion to pay money to a secured creditor in accordance with the tax debtor's instructions. It is clear however that the sale would not have proceeded if the seller was unable to provide the purchaser with clear title to the property. The implication of this case is that similar problems can arise with sales by receivers as they are treated as sales by the vendor company in receivership,

and the proceeds of sale are payable to the vendor company not the mortgagee(s). While mortgagees may be able to take steps to protect their interests, this case provides a clear example of circumstances in which the Commissioner's section 260-5 notice has taken priority to a fixed charge over the debt.

Dixon and Duncan have also considered the wide-reaching impact of section 260-5 notices, observing that *FCT v Park* [755] is 'significant and demands careful consideration by secured lenders and their advisers'. [756] They conclude that '[w]ithout careful due diligence concerning issues such as potential income tax, consents and amendments to lease and capital gains tax liability, a decision to follow the traditional and well-worn path in appointment terms (of receivers and managers) may prove to be both embarrassing for professional advisers and costly for the secured lender.' Accordingly, secured lenders and the corporate tax debtor's professional advisors will need to be clear as to the implications of FCT *v Park*[757] to avoid any adverse consequences that could result due to an issue of the Commissioner's s260-5 notice.

Interaction with PPSA Security Interests

The effect of the PPSA upon the Commissioner's statutory garnishee charge under section 260-5 must be considered in order to determine which has priority. The PPSA does not apply to, among other things, a charge that is created, arises or is provided for under a law of the Commonwealth (unless the person who owns the

[755] [2012] FCAFC 122.
[756] Bill Dixon and William D Duncan, 'Reconsidering the agency of privately appointed receiver and manager in three specific circumstances' (2013) 21 *Insolvency Law Journal* 263, 266.
[757] [2012] FCAFC 122.

property in which the interest is granted agrees to the interest).[758] Accordingly, as the charge created by service of the Commissioner's notice under section 260-5 is a security interest arising by operation of law, it is specifically excluded from the PPSA.[759]

An Act that creates a statutory charge will govern the priority between the statutory charge and a security interest regulated by the PPSA if the Act that creates the statutory charge declares that section 73(2) of the PPSA applies to the statutory charge and the statutory charge is created after that declaration comes into effect.[760] As section 260-5 does not declare that section 73(2) of the PPSA applies to the statutory charge, the TAA 1953 does not govern the priority between the section 260-5 notice and the security interest regulated by the PPSA. In these circumstances, the priority dispute falls to be determined by the general law.

In order to determine how this priority contest will be resolved, it is necessary to consider the interaction between garnishee notices and fixed and floating charges under the general law before the PPSA came into effect. As noted previously, there is clear authority that a fixed charge over a debt takes priority over a section 260-5

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[758] PPSA s 8(1)(b)

[759] See PPSA s 8(1)(l) and *Personal Property Security Regulations 2010* (Cth) reg 1.4(1).

[760] PPSA s 73(2). An example of the application of s 73(2) of the PPSA can be seen in Part 4-4 of the *Proceeds of Crime Act 2002* (Cth). Part 4-4 of that Act provides for charges over restrained property to secure amounts payable to the Commonwealth. Subsection 302C(2) of that Act provides as follows:
'(2) Subsection 73(2) of the PPSA applies to the Commonwealth's charge (to the extent, if any, to which that Act applies in relation to the property charged).
Note 1: The effect of this subsection is that the priority between the Commonwealth's charge and a security interest in the property to which the PPSA applies is to be determined in accordance with this Act rather than the PPSA.
Note 2: Subsection 73(2) of the PPSA applies to Commonwealth charges created by section 302A after the commencement of subsection (2) (which is at the registration commencement time within the meaning of the PPSA).'

notice issued in relation to a debt, however the position with floating charges was an area of considerable litigation prior to the enactment of the PPSA.[761] The leading case in the line of authorities on the question of competition between a notice and a floating charge over the taxpayer's assets is the decision of the Supreme Court of Queensland in *Elric Pty Ltd v Taylor*.[762] The Court held that where a person holds a crystallised equitable charge over the assets of a taxpayer in receivership, that person's claim to any money due to the taxpayer under the receivership takes priority to a claim by the Commissioner pursuant to a notice served by the Commissioner attempting to garnish those debts.[763] There is a substantial body of authority which supports this proposition.[764]

Under the PPSA a reference in a law of the Commonwealth or a security agreement to a charge is either a security interest that has attached to a 'circulating asset' or to personal property that is not a 'circulating asset'.[765] A fixed charge is taken to be a reference to a security interest that has attached to personal property that is not a circulating asset.[766] A floating charge is taken to be a reference to a security

[761] *Elric Pty Ltd v Taylor* (1988) 19 ATR 1551; *DCT v Lai Corporation Pty Ltd* (1986) 17 ATR 256; *DCT v Lai Corporation Pty Ltd* 18 ATR 270; *Tricontinental Corporation Ltd v FCT* (Cth) 18 ATR 827; *Elric Pty Ltd v Taylor* (1988) 19 ATR 1551; *Clyne v DCT* (1982) 56 ALJR 857; *Re Octaviar Ltd (No 8)* [2009] QSC 202.
[762] (1988) 19 ATR 1551.
[763] Ibid 50.
[764] That appears to have been the view of Brinsden J in *DCT v Lai Corporation Pty Ltd* (1986) 17 ATR 256 and Burt CJ on the appeal in *DCT v Lai Corporation Pty Ltd* 18 ATR 270, in respect of the equivalent provisions of the Sales Tax legislation. Williams J in *Tricontinental Corporation Ltd v FCT* (Cth) 18 ATR 827, Thomas J in *Elric Pty Ltd v Taylor* (1988) 19 ATR 1551 and each of the judgements in *Clyne v DCT* (1982) 56 ALJR 857 also held this view. Most recently, in the Supreme Court of Queensland decision in *Re Octaviar Ltd (No 8)* [2009] QSC 202 the views in *Elric Pty Ltd v Taylor* (1988) 19 ATR 1551 have been followed. *Octaviar Ltd (No.8)* [2009] QSC 202 was subject to appeal, however his Honour's decision on that point was not challenged in the appeal.
[765] Defined in PPSA s 340.
[766] PPSA s 339(3)–(5).

interest that has attached to a circulating asset.[767] Both fixed and floating charges will attach to the charged assets when the requirements of section 19 of the PPSA are satisfied (setting out when attachment occurs) or when the relevant security agreement provides that attachment occurs.[768] Under the PPSA, a security interest attaches when the grantor has rights in the collateral, or the power to transfer rights in the collateral to the secured party and either value is given for the security interest or the grantor does an act which creates the security interest.[769] A security interests will attach at the time the parties enter into a security agreement for value.[770] While the parties are free to defer the time of attachment by written agreement, no such agreement will be inferred from the mere reference in a security agreement to a 'floating charge'.[771] Provided that the security interest has attached and is perfected, the distinction as to whether the security is in a circulating or a non-circulating asset is irrelevant for priority purposes.[772] Under the PPSA, where the secured party's interest is perfected before the garnishee order is made, the interest of a secured party will prevail.[773] Accordingly, there will be little scope for a priority contest between a secured party with a perfected security interest under the PPSA and a section 260-5 notice.

The situation becomes more complex if the security interest remains unperfected at the time the Commissioner issues the section 260-5 notice. A security interest under the PPSA can take the form of a fixed security over present and after-

[767] Ibid.
[768] PPSA s 19.
[769] Ibid.
[770] Ibid.
[771] Ibid.
[772] Ibid.
[773] PPSA s 74(4)(b).

acquired property, including book debts. If a future book debt becomes payable to a grantor it will automatically become subject to a PPSA security interest in the grantor's present and after-acquired property. On one view, the secured party's security interest will only attach when the future book debt is acquired. Hence, the Commissioner's section 260-5 charge will prevail over the secured party's interest in the future book debts if the garnishee notice is served before the future book debts are acquired by the grantor. However, this was not the view taken in two Supreme Court of Canada decisions where the Court unanimously held that prior taken unperfected PPSA security (held by the Credit Union litigants) had priority over subsequently taken Bank Act security (held by the Bank litigants).[774] In Canada, these decisions clarify this previously unsettled point of law.[775]

In *Royal Bank of Canada* (RBC) *v Radius Credit Union Ltd*, the dispute was in respect of property acquired by the debtor after obtaining financing from the Bank. The Saskatchewan Court of Appeal held that since the interests of Radius Credit Union and the RBC attached simultaneously at the moment the debtor acquired the disputed property, the legal principle of *nemo dat quod non habet* (one cannot give what one does not have) was inapplicable.[776] Jackson JA relied on the equitable principle of *qui prior est tempore potior est jure* (first in time is first in right) to find

[774] *Bank of Montreal v Innovation Credit Union* 2010 SCC 47 and *RBC v Radius Credit Union Ltd* 2010 SCC 48. In both of these cases, the Supreme Court of Canada examined the relationship between the *Bank Act* security provisions and the PPSA.
[775] Clayton D Bangsund, 'A Critical Examination of Recently Proposed Amendments to the Bank Act Security Provisions' (2012) 75 *Saskatchewan Law Review* 216.
[776] *Radius Credit Union Limited v RBC*, 2009 SKCA 36 at para 25, 306 DLR (4th) 444.

in favour of Radius Credit Union since it acquired an executed security agreement from the debtor prior to RBC acquiring its executed security agreement.[777]

On appeal, the Supreme Court of Canada affirmed the decision, but provided different reasoning in support of its conclusion. The Supreme Court expanded the legal principle of *nemo dat quod non habet* to resolve a priority dispute between two interests that attached to after-acquired property simultaneously. Charron J, on behalf of the Court, concluded that Radius Credit Union 'acquired a statutory interest in the nature of a fixed charge over the debtor's assigned after-acquired property, which effectively derogated from the title Mr. Hingtgen had available to assign to the Bank. This interest was in existence at the time the Bank took its Bank Act security interest, although it attached to the collateral in question only subsequently.'[778]

As a result of these decisions it is now settled law in Canada that a prior taken unperfected PPSA security interest has priority over subsequently taken Bank Act security (regardless of whether the debtor acquired the collateral before or after executing the respective security agreements). Accordingly, if this approach is taken by Australian courts, it appears as though there will be little scope for a priority contest between a section 260-5 charge and an unperfected PPSA security interest over after-acquired property.

[777] Ibid para 44.
[778] Ibid para 34.

The Service of Garnishee Notices on Companies in External Administration

The Service of a Notice after a Company Has Entered Into Liquidation

Bruton Holdings Pty Ltd (In liq) v FCT[779] is a HCA case which concerned a section 260-5 notice that was issued to a company after it had entered into liquidation. The Commissioner issued Bruton Holdings Pty Ltd's solicitors with a section 260-5 notice that directed them to pay $447,420 to the Commissioner after Bruton Holdings Pty Ltd had already been placed into liquidation following the passing of a resolution of creditors. Bruton Holdings Pty Ltd was acting as a trustee of the Bruton Educational Trust. Such a garnishee notice, if valid, stood to enable the Commissioner to rank ahead of all unsecured creditors, rather than receiving a distribution on a *pari passu* basis.

The central issue for the HCA was whether a section 260-5 notice was an 'attachment' within the meaning of section 500(1) of the Corporations Act. Section 500(1) of the Corporations Act provides that any attachment against the property of a company is void if it attaches after the passing of a resolution to wind up the company. In making its decision, the HCA had to consider whether section 500(1) of the Corporations Act was limited to attachments involving a court process (also called curial attachments).

[779] [2009] HCA 32.

The HCA held that a notice issued under section 260-5 is an attachment within the meaning of section 500(1) of the Corporations Act and that the meaning of the expression 'any attachment' in that section should be given the meaning that extends to curial and non-curial attachments, including those made by ATO garnishee notices. Accordingly, the HCA upheld the appeal and held that section 260-5 notices issued by the Commissioner to collect tax owed by a company that is already in liquidation are void.[780] The Court also noted that, because of the specific tax collection and recovery scheme set out at section 260-45 of Schedule 1 to the TAA 1953, the Commissioner's general powers under section 260-5 are also not available if a court order for a winding-up is made.[781]

Subsequent to *Bruton Holdings*, the Commissioner published PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* which provides that the Commissioner will not issue a garnishee notice in respect of a debt owed to a company after an order has been made, or a resolution has been passed, for the winding up of the company.[782]

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[780] Ibid at 39. In a later decision, *Re Octaviar Limited (No 8)* [2009] QSC 202 at 47, the Supreme Court indicated that the 'attachment' issue on appeal in *Bruton Holdings Pty Ltd (In liq) v FCT* [2009] HCA 32 would not affect the validity of that garnishee notice, as that notice was served before the commencement of the winding-up. Also see the later decision of *Bell Group Limited (in liq) v Deputy Commissioner of Taxation* [2015] FCA 1056 where the Federal Court declared void two s 260-5 notices which had been issued by the DCT to the National Australia Bank requiring payment of post-liquidation tax liabilities assessed against a company in liquidation and its liquidator of over $298 million and $308 million. The Federal Court held that a section 260-5 notice is an attachment for the purposes of s 468(4) of the Corporations Act (court-ordered liquidations), which is in identical terms to s 500(1) (voluntary liquidations) which was considered in *Bruton Holdings*. Further, the Federal Court held that the reasoning of the High Court in *Bruton Holdings* with respect to the regime in s 260-45 of Schedule 1 to the TAA 1953 relating to pre-liquidation tax-related liabilities, is equally applicable in cases which involve the scheme in s 254 of the ITAA 1936 in relation to post-liquidation tax-related liabilities. .

[781] *Bruton Holdings Pty Ltd (In liq) v FCT* [2009] HCA 32 at 19 and 39.

[782] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 126.

The Service of a Notice after a Company Has Entered Into Voluntary Administration

While the decision in *Bruton Holdings* makes it clear that the Commissioner cannot effectively issue a notice in relation to a corporate tax debtor that is in liquidation, it is still possible for the Commissioner to use the notices to improve his position in a corporate insolvency, even after a company has entered into voluntary administration under Part 5.3A of the Corporations Act.

This is possible because the stay and moratorium on claims against a company in administration is not effective against such notices.[783] The Commissioner does not require leave of the court to serve a section 260-5 notice on the debtor after the appointment of an administrator because it is not an 'enforcement process' under s 9 of the Corporations Act. The term 'enforcement process' does not include attachment and the service of a garnishee notice is not a form of execution against the property of the company or another enforcement process that involves a court or a sheriff.[784] However, if the Commissioner wishes to enforce a section 260-5 notice after the appointment of an administrator to the tax debtor company, the Commissioner can only do so with the administrator's consent or with leave of the court.[785] Accordingly, the third party who receives the section 260-5 notice will be entitled to pay the debt to the Commissioner who will then be obliged to pay the amount received to the administrator, unless the administrator accepts or the court approves the Commissioner's enforcement of the statutory charge.

[783] Corporations Act ss 440D and 440F.
[784] Corporations Act s 440F.
[785] Corporations Act s 440B.

Further, in the event that a deed of company arrangement (DOCA) is entered into, section 468 of the Corporations Act, which voids dispositions of property of a company made after the commencement of a court-ordered winding up, will not act to void the section 260-5 notice.[786] This is because in the event that a DOCA is entered, there will be no court order to wind up the company. In that regard, the authority of *Macquarie Health Corporation v FCT*,[787] which held that in respect of liquidation where a company has been under administration or subject to a DOCA that the date of commencement of winding up is that date that the taxpayer is placed into administration, will not apply. Accordingly, any DOCA proposal will need to consider the interests of the Commissioner.

The Service of a Notice before the Date of Commencement of Any Winding Up, But After the 'Relation-Back Day'

It is important to appreciate the difference between the date on which the winding up of a company commences and the 'relation-back day'. The relation-back day is usually the day on which the application for the winding up order was filed. However, if the company is already in liquidation or administration at the time the winding-up order is granted, the relation-back day will relate to the date of original appointment. The situation in *Bruton Holdings* can be distinguished to cases when

[786] *Bruton Holdings Pty Ltd (in liq) v FCT* [2009] HCA 32 at 35. The 'relation-back day' is not relevant to when s468 of the Corporations Act (or its counterpart provision in respect of voluntary liquidations, Corporations Act s500), which voids dispositions and attachments made by or against a company in liquidation, takes effect. Section 468 operates with effect from the date on which the winding up commences. Accordingly, the date on which the winding up commences is the relevant date for purposes of testing the validity of the notice.
[787] *Macquarie Health Corporation v FCT* (1999) 96 FCR 238.

the Commissioner serves a notice before the date of commencement of any winding up, but after the relation-back day.

In *Brown v Brown*[788] a notice had been served on a taxpayer's debtor before the commencement of the taxpayer's winding up but after its relation-back day. It was held that the notice was valid. The effect of section 468 of the Corporations Act (voiding dispositions of the taxpayer's property after commencement of its winding up) was not applicable because it did not apply from the relation-back day but from the date of commencement of the winding up. The decision in *Brown v Brown* has not been disapproved in the subsequent decision in *Bruton Holdings* and, it seems, remains the law in Australia.[789]

Voidable Transactions

Division 2 of Part 5.7B of the Corporations Act deals with voidable transactions and provides liquidators with a means to recover property, money or compensation for the benefit of creditors of an insolvent company. Transactions that may be voidable under the Corporations Act include unfair preferences and uncommercial transactions.[790] The most common voidable transaction made by a liquidator against the Commissioner is in relation to an unfair preference.[791] The transaction is voidable if it is an insolvent transaction of the company and it was entered into, or an act was done for the purpose of giving effect to it during the six months

[788] [2007] FCA 2073.
[789] *Bruton Holdings Pty Ltd (in liq) v FCT* [2009] HCA 32, 35.
[790] Corporations Act Division 2 of Part 5.7B
[791] ATO, Law Administration Practice Statement 2011/16, *Insolvency – collection, recovery and enforcement issues for entities under external administration*, para 64.

ending on the relation back day or after that day but on or before the day when the winding up began.[792]

Macquarie Health Corp Ltd vFCT[793] makes it clear that a garnishee notice cannot be set aside as an unfair preference in the taxpayer's winding up as a notice does not involve the taxpayer entering into a 'transaction' for the purposes of section 588FA of the Corporations Act.[794] That is, the notices cannot be set aside as an unfair preference if issued six months before the relation-back day for a particular company (at a time when the company was insolvent). The Commissioner's position can be contrasted with the position of ordinary unsecured creditors, and secured creditors who can have transactions with the insolvent company that have improved their security during the 6 months before the relation-back day or winding up began.

The Commissioner's Discretion

The Commissioner has issued PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* which deals with garnishee notices. The Commissioner recognises that the issue of a garnishee notice is an exercise of a coercive power so care must be taken when exercising this power. [795] When considering whether to issue a garnishee notice, the Commissioner will have regard to:[796]

[792] Corporations Act s 588FE.
[793] (1999) 96 FCR 238.
[794] Ibid 133-134.
[795] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 101.
[796] Ibid para 102.

- the financial position of the tax debtor and the steps taken to make payment in the shortest possible timeframe having regard to the particular circumstances of the tax debtor;
- the extent of any other debts owed by the tax debtor;
- whether the revenue is placed at risk because of the actions of the tax debtor, such as the tax debtor making payment to other creditors in preference to paying the Commissioner; and
- the likely implications of issuing a notice on a tax debtor's ability to provide for a family or to maintain the viability of a business.

Review of the Commissioner's decision to issue section 260-5 notices pursuant to the ADJR Act

There are a number of recent cases where the courts have reviewed the Commissioner's decision to issue section 260-5 of the TAA 1953 notices pursuant to the *Administrative Decisions (Judicial Review) Act 1977* (Cth) (ADJR Act) on the basis that the Commissioner has failed to relevantly consider issuing a garnishee notice, and that the decision to issue the garnishee notice has been so unreasonable that no reasonable person could have so exercised the power.[797]

In the case of *Denlay v FCT*[798] the taxpayers had debts owing to the Commissioner arising from the issue of income tax assessments in the total amount of $1,058,123, which included additional amounts of undeclared offshore income held in accounts

[797] ADJR Act ss 5(2)(b) and (g).
[798] [2013] FCA 307.

of the Liechtenstein Bank. In addition, the ATO imposed administrative penalties totalling $624,785. The taxpayers commenced Part IVC of the TAA 1953 challenges to their assessments in the Federal Court. The Commissioner obtained judgment in respect of the taxpayer's outstanding debts, however enforcement of the judgment was stayed by the Supreme Court of Queensland pending the outcome of the Federal Court income tax appeals. The stay was granted because enforcement of the judgment would likely cause the bankruptcy of the taxpayers and result in their inability to prosecute their challenges to the assessments. The Commissioner challenged the stay, and was unsuccessful.

The Commissioner issued garnishee notices under section 260-5 requiring remittance to the Commissioner of the remaining amounts held in each taxpayer's superannuation account. The funds in the superannuation accounts were paid to the Commissioner and applied against the outstanding debts of the taxpayers. At the time of the decision to issue the section 260-5 notices, the stay was in place and the taxpayer’s appeal under Part IVC of the TAA 1953 was partially heard in the Federal Court. The taxpayers applied for a judicial review of the decisions under the ADJR Act.

There were two issues for the Court to consider. Firstly, whether the Commissioner failed to take relevant considerations into account in exercising his power to issue the section 260-5 notice, under s 5(2)(b) of the ADJR Act. Secondly, whether the Commissioner’s decision to issue the section 260-5 notice in circumstances where there was a stay of the enforcement of a Queensland Supreme Court judgment in respect of the taxpayer’s amended assessment-based tax liabilities and while the

tax appeals were part-heard, was so unreasonable that no reasonable decision-maker could have exercised that power.

Logan J provided the following comments in relation to the power of the judiciary to review a decision of the Commissioner to issue a garnishee notice:[799]

> In short, in respect of this error ground and in the circumstances of this case, it is a necessary discipline, flowing from the separation of powers under the Constitution, for this Court to recognise that the task of determining whether occasion has arisen on the facts for the exercise of the statutory power to issue a 260-5 notice under the TAA 1953 has been consigned by the Parliament to the Commissioner, not to the judiciary. If, in so doing, the Commissioner has, materially, taken into account the considerations which the TAA 1953 has made relevant and exercised the power reasonably, it is nothing to the point that the Court might not have so exercised the power on the basis of the material before the Commissioner. The Commissioner's decision will be unreasonable only if no reasonable administrator on that material could have so exercised the power.

A consideration will be 'relevant' for the purposes of section 5(2)(b) of the ADJR Act only if it is one which the decision-maker is bound to take into account.[800] In determining the relevant considerations in issuing a garnishee notice, the courts have taken the approach of considering the overall statutory scheme for the collection, recovery and disputing of a tax liability.[801]

A number of provisions effectively operate alongside section 260-5 of the TAA 1953. In particular, in *Denlay v FCT*[802], Logan J had to consider the relationship of section 260-5 of the TAA 1953 with Part IVC of the TAA 1953, the conclusive evidence provisions and sections 14ZZM and 14ZZR of the TAA 1953. The relationship between section 459E of the Corporations Act (statutory demand

[799] Ibid 18.
[800] *Minister for Aboriginal Affairs v Peko-Wallsend Ltd* (1986) 162 CLR 24 at 39-40.
[801] *Denlay v FCT* [2013] FCA 307, 365.
[802] [2013] FCA 307.

provision) and these provisions is considered in Chapter 8, including a fuller discussion of one of the leading authorities which examines the operation of these provisions, the Federal Court decision in *Snow v DCT*[803].

Logan J stated that section 260-5 of the TAA 1953 forms part of the overall statutory scheme, found materially not only in the TAA 1953 but also the ITAA 1936 and the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) for the ascertainment, assessment, collection, recovery and disputing of a taxation liability and because of that, the considerations set out in *Snow* are likewise relevant to an exercise by the Commissioner of the discretion which by section 260-5 of Schedule 1 to the TAA 1953.[804] Logan J remarked as follows:[805]

> I have already expressed the view that the considerations mentioned in Snow are, when they are raised on the facts, just as relevant for the Commissioner to take into account when deciding whether or not to issue a s 260-5 notice as they are for a court when deciding whether or not to stay the enforcement of a judgment issued on the basis of a debt grounded in an assessment under challenge. The Commissioner is no more entitled than a court exercising Federal jurisdiction to ignore considerations made relevant by Federal legislation. Under our system of government, the era when officers of the Crown might engage in revenue collection without taking into account parliamentary requirements ceased both literally and constitutionally upon the execution of King Charles I in 1649. It is that heritage which underpins the affirmation in WR Carpenter that a law is not one with respect to taxation if it permits the imposition of liability in an arbitrary or capricious manner.

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[803] (1987) 14 FCR 119.

[804] *Denlay v FCT* [2013] FCA 307, 356.

[805] Ibid; *WR Carpenter Holdings Pty Ltd v FCT* [2008] HCA 33 the HCA applied three propositions set out in *Giris Pty Ltd v FCT* (1969) 119 CLR 365., *MacCormick v FCT* (1984) 158 CLR 622 at 639-641 and *DCT v Truhold Benefit Pty Ltd* (1985) 158 CLR 678 at 687-688 to determine the validity tax laws under challenge: 'First, for an impost to satisfy the description of taxation in s 51(ii) of the Constitution it must be possible to distinguish it from an arbitrary exaction. Secondly, it must be possible to point to the criteria by which the Parliament imposes liability to pay the tax; but this does not deny that the incidence of a tax may be made dependent upon the formation of an opinion by the Commissioner. Thirdly, the application of the criteria of liability must not involve the imposition of liability in an arbitrary or capricious manner; that is to say, the law must not purport to deny to the taxpayer "all right to resist an assessment by proving in the courts that the criteria of liability were not satisfied in his case".'

Logan J held that the provenance of the order of the Supreme Court of Queensland to grant a stay was a relevant consideration that was not taken into account. Further, given that the appeals were, at the time when the decision was made, at an advanced stage, the merits of a Pt IVC of the TAA 1953 application were a 'highly relevant consideration'.[806] Logan J held, quashing the decision to issue the notices, that the Commissioner's decision to issue notices under section 260-5 was so unreasonable that no decision-maker, acting reasonably, could have so decided. However, Logan J made it clear that this is not to say that the stay of enforcement of the judgment bound the Commissioner not to issue the garnishee notices, only that he was bound to take the consideration into account. In that regard, Logan J remarked:[807]

> This is not to suggest that the Commissioner must, in making a s 260-5 notice decision, any more than a court considering whether or not to grant a stay, try the taxation appeals. At each extreme, for or against and on the materials to hand whether the challenged assessments are likely to be found to be excessive, an impression of the merits might, taking into account the policy evident in ss 14ZZM and 14ZZR of the TAA 1953, tell powerfully for or against the issuing of a s 260-5 notice. In between these extremes the case against the issuing of a stay may be less obvious. The decision is multifactorial and questions of weight are for the Commissioner, not for the Court. The role of the Court is limited to determining whether a consideration is relevant and whether it has been taken into account in the making of an administrative decision.

In that regard, the great weight that is given by courts to the legislative policy in sections 14ZZM and 14ZZR of the TAA 1953 which accords priority to the recovery of tax debts notwithstanding the existence of Part IVC of the TAA 1953 proceedings, will be inequitable to the vast majority of taxpayers who bring appeals on legitimate grounds.

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[806] Ibid 37-38, 66, 70-73, 76, 81.
[807] Ibid 73.

In response to this case the Commissioner has released a Decision Impact Statement which states that 'ATO officers will continue to apply the stated policy in PS LA 2011/18 at paragraph 112: Where a tax debtor is appealing to a tribunal or court against the assessments that raised the debt, the Commissioner will consider whether a garnishee would significantly prejudice the tax debtor's rights in pursuing those appeals.' [808] Accordingly, at an administrative level it appears as though there will be no change in ATO practice resulting from the decision in this case.

The Corporate Insolvency Tax Framework

It is important for the Commissioner to be able to choose from a 'rich suite of interventions' in administering and enforcing the tax law.[809] Tough enforcement measures such as the issue of a garnishee notice, if administered correctly, can protect the revenue and achieve efficiency in the tax system.[810] However, it is questionable whether these same objectives can be achieved in the context of corporate insolvency.

The discussion of the case law concerning the issuing of a garnishee notice highlights that the Commissioner is able to substantially improve his position in advance of a corporate failure to the detriment of unsecured creditors and in some instances secured creditors. In this regard, the Commissioner has a *de-facto* priority

[808] ATO, *Decision Impact Statement Denlay v Commissioner of Taxation*, issued 5 June 2013; other factors which the Commissioner can take into account before and after issuing a s260-5 notice are set out in ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* paras 100-103.
[809] OECD, *Working Smarter in Tax Debt Management* (2014) 15.
[810] Ibid 50-51. This report provides an overview of best practices in tax debt management.

in a corporate insolvency and therefore the discussion of the Framework in Chapter 4 with respect to whether the Framework is better achieved with or without a tax priority is equally as relevant to this discussion. It was concluded in Chapter 4 that the answer to this question cannot be conclusively determined and that the extent of the revenue loss will materially impact upon the criteria of fiscal adequacy, efficiency and equity and is therefore central to the discussion of whether affording the Commissioner tax priority meets the criteria within the Framework.

Two possibilities were analysed in Chapter 4, firstly, that the loss to the revenue from abolishing tax priority is minimal or revenue neutral and secondly, that the loss to the revenue from abolishing tax priority is significant. It was concluded that if the corporate rescue and simplicity gains from the removal of priority can be achieved with minimal cost to the revenue, there is a strong argument that the Framework supports the abolition of tax priority. Further, it was concluded that even if the loss to the revenue from abolishing tax priority is significant, provided that revenue neutrality is achieved in a manner that is more efficient and equitable than tax priority, the Framework will also favour the abolition of tax priority. It was also concluded that each of the criteria in the Framework can be adversely impacted if the enforcement measures employed by the Commissioner allow him to gain an advantage over unsecured creditors in corporate insolvency proceedings.

Consistently with the conclusion in Chapter 4, that the Framework favours a corporate insolvency tax where the Commissioner does not have tax priority provided that the loss to the revenue is not unduly significant, or even if it is

significant, that revenue neutrality is achieved in a manner that is more efficient and equitable than tax priority, so too should the Commissioner's *de facto* priority with respect to issuing s260-5 notices be removed. Again, this is necessary in order to harmonise the five Framework criteria which are imperative to fluid taxation and corporate insolvency laws. This is equally consistent with the widespread recommendations by law reform commissions and commentators in Australia and globally who have made uniform recommendations to abolish tax priority as mentioned in Chapter 4.

The above analysis of the Commissioner's powers in relation to the issue of a garnishee notice has particular impact on the corporate rescue criterion within the Framework. The Commissioner's power to issue a garnishee notice under Australia's current regime ensures a prompt recovery of tax debts and therefore does not offer the breathing space or respite from the collection activities required to implement a successful corporate rescue.[811] Further, in a similar way to a tax priority, by creating a *de facto* priority in favour of the Commissioner, stakeholders who play a role in rescuing the company are likely to take less interest in any proposed reorganisation which will adversely impact on attempts to implement successful corporate rescue.[812]

All of this is against a background where insolvency reform across many jurisdictions over the last 20 years has centred on developing legislation to both

[811] David R M Jackson, 'Forced Collectivization CCRA Style? Creditors Respond to the Latest Source Priority' (2002) 17(1) *National Creditor Debtor Review* 9; Stephanie Ben-Ishai, 'Technically the King Can Do Wrong in Reorganizing Insolvent Corporations: Evidence from Canada' (2004) 13 (2) *International Insolvency Review* 115.
[812] Ibid.

facilitate and promote business reorganisations and coupled with this, a trend towards the removal of tax priorities. However, this legislative instrument has allowed the Commissioner to interfere in the external administration process in a manner that was not intended at the time that tax priority was removed. Accordingly, the manner in which section 260-5 notices interrelate with the insolvency process is unsatisfactory and options for law reform must be considered. Possible options for law reform include:

- amending the TAA 1953 to make the section 260-5 notices ineffective as soon as a corporate debtor enters into any form of external administration under the Corporations Act;
- amending the TAA 1953 to make the notices ineffective, if served before the commencement of the tax debtor's winding up but after the 'relation-back day' for the tax debtor; and
- amending the Corporations Act to enable section 260-5 notices to be set aside as unfair preferences if they are issued six months before the 'relation-back day' for a tax debtor.

These reforms are likely to result in the criteria within the Framework being achieved which will result in greater harmony at the intersection of tax law and insolvency law.

Conclusion

This chapter has considered the Commissioner's power to issue garnishee notices, one of the 'firmer action' tools that the Commissioner has at his disposal to enforce the tax law and ensure prompt collection of tax debts. At the time of the enactment of the *Insolvency (Tax Priorities) Legislation Amendment Act 1993* (Cth) there was overwhelming support for the abolition of tax priority, however this chapter has highlighted that a *de facto* priority is still alive and at the Commissioner's ready disposal.

The Commissioner is increasingly relying upon this legislative instrument to create a *de facto* priority in corporate insolvencies, thereby gaining an advantage over general unsecured creditors and on occasion secured creditors. More specifically, in circumstances where a company is under external administration but the relevant external administration procedure is not court-ordered, there is case law which necessitates consideration of the Commissioner's interest in recovering outstanding tax debt. This acts to the detriment of other creditors who otherwise expect to be ranked in accordance with the *pari passu* or other rules as applicable.[813]

In doing so, it is clear that the Commissioner's primary objective is protecting the revenue. However, this comes at the expense of the external administration process, particularly corporate rescue efforts, which begs consideration of much broader factors (such as the impact on other stakeholders in a corporate insolvency) than simply the fiscal adequacy criterion. As such, in light of the

[813] Corporations Act s555

discussion of the conflict between the tax laws that have been touched upon in this chapter with insolvency law, the fiscal adequacy criterion of tax law is displacing the key objectives of insolvency law.

The Framework has been used to assess the way in which the provisions in the tax law interrelate with insolvency law. As evident from the preceding discussion, the tension between the Commissioner's focus on the revenue protection and the other legitimate objectives of corporate insolvency law is escalating, particularly in light of a breadth of recent case law entrenching the wide-reach of the Commissioner's powers. For this reason it is considered appropriate that the *de facto* priority be removed if this would not significantly impact upon the revenue, or even if the revenue is significantly impacted, that revenue neutrality be achieved in a more equitable and efficient manner than tax priority. The abolition of the Commissioner's *de facto* priority would create greater harmony between each of the equity, efficiency and simplicity criteria which the Framework embeds. Consistently with the purpose of corporate rescue initiatives, this would give companies that show signs of long term viability the best chance of survival post insolvency.

The next chapter will explore the federal tax liabilities and obligations of company directors when nearing insolvency, with particular focus upon the director penalty regime.

Chapter 7 - Recourse Against the Insolvent Company's Directors: The Commissioner's Power to Issue Director Penalty Notices

Introduction

Chapter 6 considered one option of recourse that the Commissioner can take to recover outstanding tax debts against a company that is approaching insolvency or is insolvent. Chapter 6 described the manner in which the Commissioner is able to utilise his powers to gain an advantage in a corporate insolvency which has implications for each of the criteria within the Framework, particularly in relation to being able to achieve successful corporate rescue post insolvency. This chapter considers another dimension of the Commissioner's role as a creditor in a corporate insolvency, being the Commissioner's recourse against an insolvent company's directors to recover outstanding tax debts of a company.

The first part of Chapter 7 will consider the director penalty regime under Division 269 to Schedule 1 of the TAA 1953. The provisions within this Division concern the obligation of directors to cause the company to meet its pay-as-you-go withholding (PAYG withholding) and SGC liabilities and the consequent obligation imposed on directors to cause the corporation to take certain steps. Directors who fail to meet these obligations will face personal liability, subject to certain defences. In particular, this part of the chapter will explore the legislative history of the director penalty regime, the operation of the current legislative scheme and the body of case law that has emerged in this area. The second part of this chapter will evaluate

the effectiveness of the director penalty regime in the context of corporate insolvency by applying the Framework. That is, does it achieve fiscal adequacy, promote successful corporate rescue post insolvency as well as the socio-economic criteria of equity, efficiency and simplicity?

This chapter is limited in its scope to a discussion of the director penalty regime and does not consider the recovery of unfair preferences from directors under the Commissioner's statutory indemnity in section 588FGA of the Corporations Act, PAYG withholding non-compliance tax,[814] or the prosecution for criminal offences and disqualification[815] under section 8Y of the TAA 1953 and section 21B of the *Crimes Act 1914* (Cth). The director penalty regime was selected for this chapter as it is one of the most commonly initiated ATO actions with respect to insolvency cases. Further, the most recent changes to the law regarding the Commissioner's recourse against company directors has occurred in this area.[816] An examination of these additional areas would warrant a separate thesis.

Historical Background to the Director Penalty Regime

Prior to 30 June 1993, the Commissioner had priority in bankruptcy and in a winding up over all other unsecured creditors with respect to unremitted deductions for

[814] TAA 1953, Schedule 1, Subdivision 18-D, Part 2-5.
[815] Helen Anderson, 'Directors' Liability For Fraudulent Phoenix Activity – A Comparison Of The Australian and UK Approaches' (2014) 14(1) *Journal of Corporate Law Studies* 139.
[816] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 12; Pricewaterhouse Coopers, *Insolvency Review,* Overarching Report (2013) 5-6. This review was commissioned by the ATO and within the sample size that was selected, DPNs were issued in 17 of the 19 cases of the insolvency cases; *Tax Laws Amendment (2012 Measures No. 2) Act 2012* (Cth), *Pay As You Go Withholding Non-compliance Tax Act 2012* (Cth).

group tax under the former section 221P of the ITAA 1936 and other taxes.[817] Section 221P of the ITAA 1936 gave the Commissioner priority for PAYE deductions which had not been remitted to him or used to buy tax stamps.[818] The Commissioner's priority was abolished based on recommendations by the Australian Law Reform Commission in the General Insolvency Inquiry, known as the Harmer Report.[819] The Harmer Report recommended abolition of the priorities accorded to the Commissioner over all other unsecured creditors with respect to certain amounts deducted or withheld.[820] The director penalty regime was introduced as a substitute for the Commissioner's priority.[821]

In 1993, the director penalty regime was introduced in Division 9 of the ITAA 1936. In introducing the *Insolvency (Tax Priorities) Legislation Amendment Bill 1993* (Cth) to the Parliament, the Minister for the Arts and Administrative Services at that time, Senator McMullan, said in his Second Reading Speech:[822]

> The Bill will also make company directors liable for deductions made by their company and not remitted to the Commissioner. Currently, directors can be convicted in relation to their company's non payment of amounts deducted and can be ordered by a court to pay reparation equal to the deductions not remitted. This new measure will achieve this result more efficiently. Consistent with the theme of the recent amendments to the Corporations Law, this measure will ensure solvency problems are confronted earlier and the escalation of debts will be prevented...

[817] Priority was also given to withholding tax on dividends and interest (former section 221YU), for unremitted deductions from natural resource or royalty payments (former section221YHZD) and for unremitted deductions from prescribed payments tax (former section 221YHJ).
[818] Ibid.
[819] Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988).
[820] Ibid 209-303.
[821] This statutory priority gave to Commissioner's claim over outstanding PAYE liabilities priority over some secured creditors, employees and unsecured creditors. Accordingly, the outstanding PAYE liabilities had to be paid before these other claims were considered. This was seen as unfair to employees and other unsecured creditors.
[822] Senate Weekly Hansard No 3 (1993) 880. Also see, *DCT v Falzon* [2008] QCA 327 at 14-15.

The 1993 Act also included measures to enable the Commissioner to take action earlier to recover the unremitted amounts through an estimation process. These measures were also aimed at encouraging directors *'*to face emerging problems as soon as possible*'.*[823]

The regime that was set out in the Division 9 of the ITAA 1936 was amended on 1 July 2010 by the *Tax Laws Amendment (Transfer of Provisions) Act 2010* (Cth). The 2010 Act repealed the parts of the ITAA 1936 that set out director obligations and re-wrote them in Division 269 to Schedule 1 of the TAA 1953 using plain English and modern drafting techniques.[824] It is clear from the Explanatory Memorandum that the amending Act was not intended to involve policy changes.[825]

The most recent changes to the director penalty regime were prompted by the need to deter directors who engage in fraudulent phoenix activities.[826] A proposals paper by the Australian Government Treasury entitled 'Action Against Fraudulent Phoenix Activity' in 2009 (Proposals Paper), reported that losses to the revenue authorities caused by fraudulent phoenix activity were estimated to run into the

[823] Second Reading Speech, Hansard, *Senate*, 19 May 1993 879, 880
[824] Matthew Broderick, 'Legislative change to director penalty notices and security for tax payments' (2011) 40 *Australian Tax Review* 60, 60.
[825] Explanatory Memorandum, *Tax Laws Amendment (Transfer of Provisions) Bill* 2010 [1.8]-[1.9].
[826] A number of Government enquiries have examined phoenix activity. These include Victorian Law Reform Committee, *Curbing the Phoenix Company—First Report on the Law Relating to Directors and Managers of Insolvent Corporations*, Report No. 83 (1994); Law Reform Commission of Western Australia, *Financial Protection in the Building and Construction Industry*, Project No 82 (1998); Royal Commission into the Building and Construction Industry, *Final Report* (2003); Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake* (2004); PricewaterhouseCoopers, *Phoenix Activity: Sizing the Problem and Matching Solutions,* Prepared for the Fair Work Ombudsman (2012); NSW Government, *Inquiry into Construction Industry Insolvency in NSW*, Final Report (2013); Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015).

hundreds of millions of dollars and were growing.[827] The Proposals Paper described basic and more sophisticated forms of fraudulent pheonixing. Basic pheonixing was described as a company which has failed to pay its debts being liquidated and then the business being taken over by a newly-incorporated company,[828] and phoenix activity within corporate groups was described as the sophisticated form of phoenixing.[829]

The Proposals Paper resulted in the enactment of *Tax Laws Amendment (2012 Measures No. 2) Act 2012* (Cth) and the *Pay As You Go Withholding Non-compliance Tax Act 2012* (Cth) on 29 June 2012 (2012 amendments). These Acts made legislative amendments to the directors' penalty provisions in Division 269 of Schedule 1 to the TAA 1953 and associated measures were enacted. Three principal changes were given effect by the 2012 amendments including a more limited ability to have director penalties remitted, director penalties in relation to unpaid SGC liabilities and the introduction of a PAYG withholding non-compliance tax for directors and certain associates. The 2012 amendments generally apply from 30 June 2012. As a result of these changes, the Commissioner's powers regarding the director's penalty regime have been broadened.[830] Whilst these changes were enacted so as to deter fraudulent phoenix activities, an auxiliary effect is that the

[827] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 5–6; Bill Shorten, *Protecting Employee Super and Strengthening the Obligations of Company Directors*, Media Release, No 138, October 2011.
[828] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 2.
[829] Ibid.
[830] *The Tax Laws Amendment (2012 Measures No 2) Bill 2012* (Cth); it has been observed that '[t]his legislation in particular is nasty because it actually exposes new directors coming to a company after there has been a failure to collect relevant superannuation for potential personal liability for that amount (the Tax Office has the ability to sue them rather than the previous directors)' in Robert Baxt, 'Editorial' (2012) 40 *Australian Business Law Review* 137, 141.

2012 amendments apply to all directors who fail to meet the company's PAYG withholding and SGC obligations.[831]

The Current Director Penalty Regime

Liability to remit taxes

The system of withholding PAYG deductions from the salary or wages of an employee for the purpose of remitting those deductions to the Commissioner on behalf of the employee is provided for in Division 12 of Schedule 1 to the TAA 1953.[832] The requirement to remit those monies to the Commissioner is contained in Subdivision 16-B of Schedule 1 to the TAA 1953.[833]

Under Division 268 in Schedule 1 of the TAA 1953, the Commissioner may make an estimate of the unpaid and overdue amount of unremitted PAYG withholding and SGC amounts.[834] The amount of the estimate must be what the Commissioner thinks is reasonable.[835] The Commissioner must give to the employer written notice of the estimate,[836] and the amount of the estimate becomes due and payable upon that notice being given.[837]

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[831] Explanatory Memorandum, *Tax Laws Amendment (2012 Measures no. 2) Bill (2012)* (Cth); Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009). Substantially amended other relevant federal legislation: SGAA 1992 and Corporations Act.
[832] TAA 1953 s 12-35 provides 'An entity must withhold an amount from salary, wages, commission, bonuses or allowances it pays to an individual as an employee (whether of that or another entity).'
[833] TAA 1953 s 16-70(1) provides 'An entity that withholds an amount under Division 12 must pay the amount to the Commissioner in accordance with this Subdivision'.
[834] TAA 1953 s 268-10(1).
[835] Ibid.
[836] TAA 1953 s 268-15.
[837] TAA 1953 s 268-20(1).

Part 3 of the *Superannuation Guarantee (Administration) Act 1992* (Cth) (SGAA 1992) provides an obligation on an employer to pay SGC.[838] These provisions create a liability upon the company to remit taxes to the Commissioner and are at the centre of the director penalty regime in Division 269.

The Object of Division 269

The relevant object of Division 269 is stated in section 269-5 of the TAA 1953:

> The object of this Division is to ensure that a company either:
>
> (a) meets its obligations under:
>
> (i) Subdivision 16-B (obligation to pay withheld amounts to the Commissioner); and
>
> (ii) Division 268 (estimates of PAYG withholding liabilities and superannuation guarantee charge); and
>
> (iii) Part 3 of the SGAA 1992 (obligation to pay superannuation guarantee charge); or
>
> (b) goes promptly into voluntary administration under the Corporations Act or into liquidation.

This objective is achieved by imposing personal liability on directors of companies that do not either meet their obligations or promptly go into administration or liquidation.[839]

Scope of Division 269

Division 269 of the TAA 1953 applies if on a particular day (the initial day), a company withholds an amount under section 12-35 of the TAA 1953, receives an alienated personal services payment, provides a non-cash benefit or is given a

[838] SGAA 1992 s 16 provides 'Superannuation guarantee charge imposed on an employer's superannuation guarantee shortfall for a quarter is payable by the employer'.
[839] TAA 1953 s 269-5; ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 47.

notice of an estimate under Division 268 of the TAA 1953 and the company is obliged to pay that amount to the Commissioner on or before a particular day (the due day).[840] Division 269 of the TAA 1953 also applies if on a particular day (the initial day), a quarter ends and the company is obliged to pay the SGC for the quarter in accordance with the SGAA 1992, on or before a particular day (the due day).[841]

The due day for amounts withheld under section 12-35 of the TAA 1953 is dependent upon the size of the withholder.[842] In relation to alienated personal services payments, non-cash benefits and estimates under Division 268, the due day is the same as the initial day.[843] The company's SGC for a quarter under the SGAA 1992 is treated as being payable on the day by which the company must lodge a superannuation guarantee statement for the quarter under section 33 of that Act, even if the charge is not assessed under that Act on or before that day.[844]

Director's Obligations

Section 269-15 of the TAA 1953 provides that the directors[845] of the company on or after the initial day (generally, the day when the company withholds an amount) [846] must cause the company to comply with its obligation.[847] The director's

[840] TAA 1953 s 269-10(1) Items 1-4.
[841] Ibid Item 5.
[842] TAA 1953 s 16-75.
[843] TAA 1953 s 269-10 Note.
[844] TAA 1953 s 269-10(3).
[845] The term 'director' also includes de facto or shadow directors. See *DCT v Solomon*; *DCT v Muriwai* [2003] NSWCA 62; *DCT v Austin* (1998) 39 ATR 485; Martin Markovic, 'When Are You a Director When You're Not a Director? The Law of De Facto Directors' (2007) 25 *Company and Securities Law Journal* 101.
[846] TAA 1953 s 269-10(1).
[847] TAA 1953 s 269-15(1).

obligation to cause the company to meet its obligation to pay a PAYG withholding or SGC liability commences from the time an amount is withheld or the end of the SGC quarter respectively.[848] The directors of the company continue to be under their obligation until:[849]

- the company complies with its obligation; or
- an administrator of the company is appointed under section 436A, 436B or 436C of the Corporations Act; or
- the company begins to be wound up.

Imposition of a Penalty

The effect of section 269-20 of the TAA 1953 is that if, at the end of the due day, the directors of a company are still under an obligation imposed by section 269-15 of the TAA 1953, a person who was under such an obligation at or before that time is liable to pay to the Commissioner a penalty equal to the unpaid amount of the company's liability.[850] The penalty is due and payable at the end of the due day.

The Commissioner must not commence or take a procedural step as a party to proceedings to enforce an obligation or to recover a penalty of a director if an arrangement that covers the company's obligation is in force under section 255-15 of the TAA 1953 (Commissioner's power to permit payments by instalments).[851]

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[848] *Simpson & Others v DCT* 96 ATC 4661.
[849] TAA 1953 s 269-15(2).
[850] TAA 1953 ss 269-20(1) and 269-20(2).
[851] TAA 1953 s 269-15(3). Prior to 1 July 2010, the Commissioner had specific powers to enter into payment agreements with companies under section 222ALA in Division 8 of the ITAA 1936. That section (along with the rest of Division 8) has been repealed. From 1 July 2010, any payment arrangements must be made under section 255-15 of Schedule 1 to the TAA 1953.

However, a director's obligation does not cease as a result of the Commissioner's exercise of power to permit payments by instalments, nor is the penalty for failure to comply with the obligation removed or remitted. Rather, that obligation remains upon the director and the Commissioner is simply unable to collect the money or penalty while an instalment agreement is in place.[852]

There is clear authority that the director penalty regime applies to directors that are appointed for a short period of time and to new directors appointed after the due date for remission has passed.[853] In *Fitzgerald v DCT* (1995) 68 ATR 770, a director was held to be liable even though he was only appointed for a period of 17 days, and at a time after amounts for unremitted prescribed payment deductions were due and payable by the company. In relation to the liability of a new director, French J commented that '[t]he provisions providing for penalties for directors pursuant to Division 9 have been in force since July 1993 so that it is the responsibility of a new director at or prior to taking up his appointment to make inquiries of the relevant officers of the company as to whether there were any moneys owing by the company to the respondent.'*[854]*

As a result of the 2012 amendments, new directors are given a 30 day period in which to comply with their obligation under section 269-15 of the TAA 1953,[855] with the penalty becoming due and payable at the end of the 30th day.[856] This provides new directors with a slightly longer period (prior to the 2012 amendments

852 TAA 1953 ss 269-25(1) and 269-15(3); Matthew Broderick, 'Legislative change to director penalty notices and security for tax payments' (2011) 40 *Australian Tax Review* 60, 62.
853 *DCT v George* [2002] NSWCA 336.
854 *Fitzgerald v DCT* (1995) 68 ATR 770, 359.
855 TAA 1953 269-20(3); *Fitzgerald v DCT* 68 ATR 770, 772.
856 TAA 1953 s 269-20(4).

the period was 14 days) in which to make the relevant inquiries in relation to the tax affairs of the company and to act accordingly.

There is also clear authority that the director penalty regime applies to retired directors of a company.[857] In the case of *DCT v Power*,[858] Johnson J considered the operation of sections 269-15 and 269-20 of the TAA 1953 and stated that a director will become liable to a penalty if, at the end of the due day, the company has not complied with its obligations, and that person was under an obligation to cause the company to comply by reason of having the status of director 'at any time prior to the due day'.[859] His Honour went on to say that '[a]ccordingly, a proper construction of the legislation indicates that the obligation is indeed a continuing one, and that it survives any renunciation of directorial duty.'[860] One commentator suggests that personal liability for retired directors of a company may continue for some time as the state and territory limitation actions may not apply to a penalty recoverable under a DPN.[861]

Formal Notice Requirements

The Commissioner must not commence proceedings to recover the penalty until the end of 21 days after the Commissioner gives notice of the penalty.[862] The notice must set out what the Commissioner thinks is the unpaid amount of the company's

[857] See for example, *DCT v Solomon* (2003) 52 ATR 279, 9-11; *Fitzgerald v DCT* (1995) 68 ATR 770 and *Canty v DCT of Taxation* [2005] NSWCA 84.
[858] [2012] NSWSC 995.
[859] Ibid, 364.
[860] Ibid.
[861] Matthew Broderick, 'Company Directors: Federal Taxation Liabilities and Obligations When Nearing Insolvency – Part 1' (2009) 38 *Australian Tax Review* 12.
[862] TAA 1953 s 269-25(1).

liability, state that the director is liable to pay to the Commissioner, by way of penalty, an amount equal to that unpaid amount because of an obligation that the director has or had under Division 269 of the TAA 1953 and explain the main circumstances in which the penalty will be remitted.[863] A single notice may relate to two or more penalties.[864]

A considerable amount of litigation in relation to the director penalty regime has concerned the validity of notices served by the Commissioner, particularly in relation to the former regime in the ITAA 1936.[865] In the majority of these cases the Commissioner has been successful and the notices have been held to be valid. In the case of *Power v DCT*,[866] a DPN did not state, in express terms, that the director's liability was because of an obligation that he had under Division 269 of the TAA 1953. The question was whether that is a critical element of the requirement of section 269-25(2)(b) of the TAA 1953. In the New South Wales Court of Appeal, Emmet JA referred to *DCT v Woodhams*[867] where the HCA identified two purposes of a section 222AOE notice of the ITAA 1936 (predecessor to section 269-25 of the TAA 1953). The first was to inform the recipient of the unpaid amount of a company's liability and of the recipient's liability to a penalty in the same amount. The second was to inform the recipient of the alternative courses available which would result in remission of the penalty.[868] The New South Wales Court of Appeal

[863] TAA 1953 s 269-25(2).
[864] TAA 1953 s 269-25(3).
[865] See for example, *Reardon v Deputy Commissioner of Taxation* (2013) 275 FLR 9; *Deputy Commissioner of Taxation v Zammitt* (2014) 284 FLR 212; *Kiff v Deputy Commissioner of Taxation* (2005) 61 ATR 361.
[866] [2013] NSWCA 428.
[867] [2000] HCA 10 [36].
[868] *Power v DCT* [2013] NSWCA 428, 48.

held that the giving of the notice to the director fulfilled the legislative purpose of section 269-25 of the TAA 1953 and accordingly, the fact that the notice did not expressly state the source of the obligation in the present matter did not render the notice invalid.[869]

The Commissioner may give notice under section 269-25 of the TAA 1953 by leaving the DPN at, or posting it to, an address that appears from information held by ASIC to be, or to have been within the last 7 days, the director's place of residence or business.[870] The Commissioner may also give a copy of a DPN to a director's registered tax agent (for the purposes of any tax law) by leaving the copy at or posting the copy to the address of the registered tax agent.[871] It is considered that a tax agent would have the professional knowledge to advise the director of the importance of the notice and the actions the director can take.[872]

Prior to the introduction of Division 269 of the TAA 1953, there was considerable ambiguity in relation to the issue of when the notice was 'given' under the former section 222AOE of the ITAA 1936 and upon non-delivery of a notice.[873] Section 269-25(4) of the TAA 1953 provides that the notice is 'taken to be given' upon the

[869] *Power v DCT* [2014] HCA 198, 'The decision of the Court of Appeal is plainly right'.
[870] TAA 1953 s 269-50.
[871] TAA 1953 s 269-52(2).
[872] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 49.
[873] *DCT v Meredith* [2007] NSWCA 354 held that the date upon which a DPN was *'*given*'* for the purpose of section 222AOE of the TAA 1953 is on the date it was posted. The decision in Meredith was overruled in *Soong v DCT* [2011] NSWCA 26. The Court unanimously held that a DPN was *'*given*'* for the purposes of s222AOE of the TAA 1953 when it was delivered rather than, as held in *Meredith*, when it was posted. Special leave to appeal to the HCA from the decision in Soong was refused on 12 August 2011. In response to the decision in *Soong*, on 29 November 2011 the Commonwealth Parliament enacted the *Tax Laws Amendment (2011 Measures No. 7) Act 2011* (Cth) which inserted Schedule 7 into the TAA 1953 to overcome the decision in *Soong* and to reinstate the *Meredith* decision.

Commissioner leaving it at or posting it to the address of the director. The operation of this provision was considered in *Roche v DCT* where Newnes JA stated that:[874]

> Section 269-25(4) provides that the notice is 'taken to be given' upon the Commissioner leaving it at or posting it to the address of the director. The clear intention is that the act of leaving or posting the notice constitutes the giving of the notice to the intended recipient for the purposes of section 269-25(1). Upon the leaving or posting of the notice the requirements of section 269-25(1) have been met. The obvious purpose is to avoid any question as to the time of delivery or any issue of non-delivery of the kind now sought to be raised by the appellant and which might otherwise be open under section 29(1) of the Acts Interpretation Act.

Accordingly, a DPN is effective at the time that the Commissioner posts the notice, regardless of whether delivery actually occurs or how long the notice takes to get delivered. The risk that the DPN may be lost in the postal system is placed upon the director.

Remittance of a Penalty

Where a PAYG withholding or SGC liability is reported within three months of the liability's due date for lodging a return,[875] remission of the relevant penalty will occur if payment is made or if the company is placed into administration or liquidation before a DPN is issued or within 21 days of the DPN being given. However, if the PAYG withholding or SGC liability is not reported within three months of the due date for lodging a return then remission of the penalty relating to the unreported amount will not occur after that three month period if the company is placed into administration or liquidation before a DPN is issued or

[874] *Roche v DCT* [2014] WASCA 194, 279.

[875] For the purposes of Division 269 of Schedule 1 to the TAA 1953 the company's SGC for a quarter is treated as being payable on the day by which the company must lodge a superannuation guarantee statement for the quarter under section 33 of the SGAA.

during the 21 day period following the DPN being given.[876] The only manner in which remission can occur in this case is if payment is made.

Prior to the 2012 amendments, directors were able to avoid the director penalty provisions for unreported PAYG withholding and SGC liability by seeking to appoint a liquidator or administrator within 21 days of the DPN being given, leaving the Commissioner unable to recover against directors personally. However, as a result of the 2012 amendments the defence provided by section 269-30 in Schedule 1 of the TAA 1953 has been qualified by section 269-30(2) of the TAA 1953.[877] This was confirmed in the case of *DCT v Roche*[878] which held that if the company had debt outstanding on 29 June 2012, and that debt had not been reported to the ATO within 3 months of the due date, then as at 29 June 2012, the remittance options available to directors in respect of the director penalty are reduced to one (being payment).[879] Sanderson J stated that 'the removal of the remission provision simply means a process which could have led to the termination of the obligation is no longer available. The obligation remains. There has been no change to the status of the director because an obligation which existed continues to exist.' Accordingly, a director who could have secured the remission of a penalty by causing one of the things specified in section 269-15(2) of the TAA 1953 to occur before being served, or within 21 days of being served with a DPN, would cease to be able to do so. Accordingly, the 2012 amendments have considerably increased the personal

[876] TAA 1953 s 269-30(2).
[877] *Tax Laws Amendment (2012 Measures No 2) Act 2012* (Cth) Section 2 and Division 3 of part 1 in Schedule 1.
[878] [2014] WASC 222.
[879] Ibid 38.

liability of directors of companies that have existing unremitted liabilities that are unreported which relate to a period before 29 June 2012.

As a result of the 2012 amendments, the provisions concerning remittance of a penalty for new directors have changed. For a director appointed after the due date for lodging a return of the company's PAYG withholding or SGC liability, any penalty relating to an unreported liability will be remitted if the company is placed into liquidation or administration within three months after the day the person became a director, regardless of how long the company has been liable for the debt. After this three month period the penalty will not be remitted should the company go into liquidation or administration. However, if the liability was reported within the three month period starting after the day the person was appointed director, the penalty will be remitted if liquidation or administration commences before a DPN is issued or within 21 days of such a notice being given.[880]

Defences

There are three defences to a DPN which are discussed below that must be raised within 60 days of notification.[881] The penalty will not be payable if the defence is raised within this timeframe and the Commissioner is satisfied that the director's circumstances meet one of the statutory defences.[882] Whether a director is able to satisfy the requirements to make out a statutory defence will depend on the facts

[880] TAA 1953 s 269-30(3).
[881] TAA 1953 ss 269-35 and 269-30(3).
[882] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 57.

of each case.[883] A director who is dissatisfied with the Commissioner's decision to reject the defence may request a statement of reasons relating to that decision under section 13 of the ADJR Act[884] and may also elect pursuant to section 5 of the ADJR Act to make an application to the Federal Court or Federal Circuit Court to seek a review of the decision.

Non-Participation

Firstly, section 269-35(1) of the TAA 1953 provides a defence in the proceedings against a director if it is proved that, because of illness or for some other good reason, it would have been unreasonable to expect the director to take part, and the director did not take part, in the management of the company 'at any time' when they were a director of the company and the directors were under the relevant obligations under section 269-15 of the TAA 1953.[885]

The case of *DCT v George* considered the operation of this defence under the predecessor provision in the ITAA 1936.[886] In that case, a company failed to comply with its obligations to remit PAYE deductions to the Commissioner. The director did not participate in the management of the company between September 1996 to June 1999 as during that time he was an acting judge. The director argued that he fell within this defence as there was a good reason for him not to take part in the management of the company due to the perception that he should so refrain

[883] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 61.
[884] *Ruddy v DCT* (1998) 82 FCR 337.
[885] TAA 1953 ss 269-35(1) and 269-35(2); As a result of the 2012 amendments this defence is now more difficult to establish as it now includes an objective element, see Matthew Broderick, 'Legislative Change to Director Penalty Notices and Security for Tax Payments' (2011) 40 *Australian Tax Review* 63.
[886] (2002) 55 NSWLR 511.

as an acting judicial officer. The trial judge found the director had not taken part in the management of the company for a period from September 1996 to June 1999 for 'good reason' pursuant section 222AOJ(2) of the ITAA 1936 (former section 269-35(1) of the TAA 1953), and was therefore liable to a penalty only in respect of the period after June 1999. The DCT appealed. The New South Wales Court of Appeal allowed the appeal and held that this defence can only succeed if the illness or other good reason continues for the whole of the time the director is in office and the obligation to comply with section 269-15 of the TAA 1953 continues. Justice Gzell considered the meaning of the words 'at any time' in the predecessor to s269-35(1) of the TAA 1953:[887]

> The words "at any time" in section 222AOJ(2) related to the period when a person was a director and the directors were under an obligation to comply with section 222AOB(1). That means, in my view, that the director had to establish good reason for non-participation in the management of the company throughout the period the person was a director and the directors were under a section 222AOB(1) obligation. The defence was not enlivened if merely because on one or more discrete occasions during that entire period the director had good reason not to participate in the management of the company. The requirement was that a director did not take part in management at any time. That requirement was not satisfied if there was participation on one or more occasions. No participation at any time meant non-participation at all times. The submission of the respondent does not give weight to the negative requirement. In my view, a director who established that at some time during the directorship when under a section 222AOB(1) obligation, there was good reason for non-participation in the management of the company, did not gain a defence to a penalty under section 222AOC or section 222AOD based on an obligation continued by section 222AOB(3) at a time when there was no continuing defence.

The director was therefore liable to pay the penalty as calculated over the entire period the company was under the obligation of section 269-15 of the TAA 1953. Accordingly, the non-participation defence is only available if a director establishes good reason for failing to take part in the management of the company for the

[887] Ibid 517 at 21-26.

entire period when they are under an obligation of section 269-15 of the TAA 1953, making it extremely difficult for a director to rely upon this defence.

DCT v Clark[888] was a case that considered the operation of the defence in section 588FGB(5) of the Corporations Act which is similar to the non-participation defence discussed in relation to the director penalty regime under section 269-35(1) of the TAA 1953. Speigelman CJ undertook an exhaustive examination of the authorities and the legislation in relation to director's duties.[889] In particular, he discussed the recent statutory reform and case law highlighting the higher standard that is expected of directors with regard to participation in the management of a corporation and, with particular reference to the application of gender neutrality, to insolvent trading.[890] His Honour said '[t]he focus of attention must be on what constitutes a 'good reason' for a director not to participate in management for the purposes of corporations law. This requires consideration of the duties of directors, particularly in, but not limited to, situations of insolvent trading. In my opinion, the process of interpretation should commence with a recognition that, for the reasons outlined above, it is a basal structural feature of corporations legislation in Australia that directors are expected to participate in the management of the corporation.'[891]

His Honour then went on to consider by way of analogy materials drawing on the concept of *'sexually transmitted debt'*. That is, the position of spouses who are directors of a corporation but really have no interest in the day-to-day

[888] [2003] NSWCA 91.
[889] Ibid 52-168.
[890] Ibid 141.
[891] Ibid 141, 142.

management of the business. His Honour then concluded that in his opinion, '[t]here is no justification for a doctrine which would hold sleeping directors to be "de facto nondirectors", who should be relieved of their liabilities. Although, as a practical matter, the conduct of such directors may never meet the requisite standard of participation in management, such conduct should not be excused as a "good reason" in law.'[892]

Accordingly, corporate law is progressively tightening the obligations of directors with regard to participation in the management of a corporation and it places a responsibility upon all directors of a company to ensure that they are aware of the company's financial position, or risk facing penalty.[893]

All Reasonable Steps

Secondly, section 269-35(2) of the TAA 1953 provides a defence in the proceedings against a director if it is proved that the director took all reasonable steps to ensure that the directors complied with their relevant obligations under section 269-15 of the TAA 1953 or there were no such steps that they could have taken.[894] That is, the director took all reasonable steps to ensure:

- the company complied with its obligations; or

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[892] Ibid 149.

[893] Geof Stapledon and Jon Webster, 'Directors' duties and corporate governance' (2004) 22 *Company and Securities Law Journal* 535, note there has been a 'natural judicial progression over the past century from the "shedding" of protection from liability for sleeping or passive directors to a move to impose upon all directors of companies, executive or otherwise, a "core, irreducible requirement of involvement in the management of the company'. Philip Crutchfield and Catherine Button, 'Men over board: The burden of directors' duties in the wake of the Centro case' (2012) 30 *Company and Securities Law Journal* 83, 94, a director's role can hardly be categorised as 'guiding and monitoring'.

[894] TAA 1953 s 269-35(2).

- an administrator of the company was appointed under section 436A of the Corporations Act; or

- the company began to be wound up.

This defence requires the director to demonstrate, in respect of all of the options in section 269-15 of the TAA 1953, that all reasonable steps had been taken or that there were no steps that the director could have taken.[895] In determining what reasonable steps could have been taken, regard must be had to when, and for how long, the director took part in the management of the company as well as all other relevant circumstances.[896] In the case of a director who was a director at the time the tax liability was incurred by the company, it is necessary to consider whether the defences are established for the whole of the period between the due date and the expiry of the notice.[897] In *Miller v DCT,* Priestley JA addressed this issue by explaining that '[p]roof that nothing could have been done at various times during this period would not establish that nothing could have been done at other times. Proof that the person took all reasonable steps at various times would not establish that he or she took all reasonable steps.'[898] The length of the action period will, however, also be a relevant consideration.[899]

DCT v Saunig demonstrates the difficulty in establishing this defence.[900] In this case, a director was prosecuted for failure to remit PAYG withholding amounts. The

[895] *Miller v DCT* (1997) 26 ACSR 533, 538; *Canty v DCT* [2005] NSWCA 84, 33.
[896] TAA 1953 s 269-35(3).
[897] *Canty v DCT* [2005] NSWCA 84, 42, 45.
[898] *Miller v DCT* (1997) 26 ACSR 533, 538, 4067.
[899] *Canty v DCT* [2005] NSWCA 84.
[900] [2002] NSWCA 390.

director was concerned about the competency of company management and made inquiries which led him to discover the company had not remitted PAYG withholding. The director then took action to determine how much PAYG withholding had not been remitted and made payments to the Commissioner and contacted the ATO in an attempt to reach an agreement as to payment. The Commissioner subsequently issued the director with a DPN and commenced proceedings against the director on the grounds that he failed to comply with his obligations. The director argued that he fell within this defence. The trial judge found that the director had taken all reasonable steps to ensure that the company complied with its obligations.

The Commissioner appealed the decision of the trial judge and the New South Wales Court of Appeal overturned the decision, holding that the appellant's *'*conduct must be judged not only by reference to what he knew but also by reference to what he ought to have known. He ought to have known ... that the ... deduction payments ... were not being passed on to the Taxation Office*'*.[901] The Court of Appeal held that a reasonable director would have sought legal advice from a lawyer or practical advice from an accountant at an earlier stage which may have led to a change in the other director's behaviour toward compliance or alternatively led to the director to wind up the company in his capacity as a director.[902] The Court considered that it was open to the director acting alone to cause the company to take the third step contemplated by the predecessor to

[901] *DCT v Saunig* [2002] NSWCA 390, 731; see *DCT v Solomon* (2003) 199 ALR 325, 335.
[902] *DCT v Saunig* [2002] NSWCA 390, 734. *DCT v Roget [No 2]* [2014] WADC 25, 'There is in my view a real question to be tried in relation to the defence under this defence' (former s 222AOJ(3)).

section 269-15(2)(c) of the TAA 1953, namely to cause the company to 'begin to be wound up' under the Corporations Act.[903] Accordingly, the director did not make out the defence and was found liable for his failure to remit PAYG withholding amounts.

In *DCT v Roche* a director was prosecuted for failure to remit PAYG withholding amounts.[904] The case involved a director who was attending university and did not attend the company's premises or review its affairs 'on a day to day basis'. The Western Australia Supreme Court held that the director was liable for unpaid PAYG withholding amounts despite the fact that he had limited involvement in the company's activities. With regard to the director's involvement with the company, Master Sanderson commented that '[w]hat is striking about the evidence of the defendant is its lack of detail. Presumably it reflects the level of his involvement with the day to day operations of the company. Clearly then he knew little of what was happening and how the company was placed financially. He appears to have been what is sometimes called a "sleeping director". Being a sleeping director is a very dangerous pastime.' [905]

The director appealed Master Sanderson's decision and the Western Australian Court of Appeal dismissed the appeal. The Court of Appeal said that to establish a defence under section 269-35(2) of the TAA 1953, the appellant was required to prove that from the time he came under the obligation in section 269-15 of the TAA 1953 he took all reasonable steps to ensure that one of the section 269-35(2)(a) of

[903] *DCT v Saunig* [2002] NSWCA 390, 733.
[904] [2014] WASC 222.
[905] Ibid, 22.

the TAA 1953 events occurred or that there were no reasonable steps that he could have taken to ensure that any of those events happened.[906] The Court of Appeal made the following observation:[907]

> The evidence, which, as the master observed, was conspicuous for its paucity, fell a long way short of that. The contention that, prior to the appointment of the administrator, it was reasonable for the appellant to take no steps in light of the information provided to him by Mr Roche and by Mr Williams at their periodic meetings is simply unsustainable.
>
> …There was no evidence that the appellant ever took any steps to satisfy himself there was a system or process in place to ensure that FTP's obligations to the Commissioner were complied with. There is nothing to suggest that the appellant ever turned his mind to the matter.

Accordingly, the non-involvement in the company's affairs did not reduce the director's liability and the director was liable for the DPN.

New Directors

In *Fitzgerald v DCT*, the appellant was a director for only 17 days, and at a time after amounts for unremitted prescribed payment deductions were due and payable by the company.[908] The Commissioner served a notice of penalty on the director pursuant to the predecessor to section 269-25 of the TAA 1953 and subsequently obtained summary judgment for payment of the penalty. On appeal the director argued that he fell within this defence as he did not take part in the management of the company, he was not aware of the tax debt until he ceased being a director and he was not in a position to take reasonable steps to ensure payment.

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[906] [2015] WASCA 196 at 40, 44.
[907] [2015] WASCA 196 at 40, 44; At all material times, the appellant was a director of Fuel Tank & Pipe Pty Ltd (FTP). The total amount FTP had failed to remit over that period was $3,409,317.56.
[908] (1995) 68 ATR 770.

It was held that, even though it seemed harsh, the legislation clearly provided that the liability of a new director arose after the expiration of 14 days after the director's appointment (this has been extended to 30 days under section 269-20(3) of the TAA 1953). Judge French explained that '[a]lthough it is clear that the appellant was not aware of the company's failure to comply with the provisions of section 222AOB, there is nothing in the affidavit material before me that would suggest that he may have a defence to the respondent's claim. Although he was only a director for a period of 17 days there is nothing to suggest that he did not take part in the management of the company. Although he was not aware of the company's financial position or the moneys due to the respondent this is not sufficient to provide a defence.' [909] Accordingly, the fact that the appellant was not aware of the existence of the tax debt did not suggest that there were no reasonable steps that could have been taken to ensure compliance with the relevant provisions.

Retired Directors

In *Canty v DCT* an appellant director was one of two directors of a printing company.[910] The director managed production and sales, and his co-director was responsible for accounting matters and finance. The company failed to remit PAYG withholding amounts and the Commissioner issued a DPN to the director after he had resigned. The director failed to comply with the notice and was prosecuted by the DCT for a penalty equivalent to the amount of the unremitted group tax. The director argued that he fell within this defence because he had delegated

[909] Ibid 359. Section 222AOB being the equivalent to s 269-15 of the TAA 1953.
[910] [2005] NSWCA 84.

performance to his co-director following the sale of the company's property and relied on his verbal assurances that the current group tax liabilities were being paid on time.

The New South Wales Court of Appeal held that the director did not establish that he took 'all reasonable steps' to ensure compliance. In the light of his knowledge of the financial difficulties, arrears and past defaults, the director did not act reasonably in accepting his co-director's assurances. The Court suggested that in order to have fallen within this defence, a former director would have had to make an urgent application to the Court for a winding up in the capacity of a shareholder or creditor. The Court explained that 'the former director will be a contingent or future creditor because of the right of indemnity against the company for the penalty the Commissioner is seeking to recover. In that capacity he or she is entitled to make an urgent application for a winding up order (See now Corporations Act s 462(2)(b), (4)). A company which cannot pay its group tax over many weeks is prima facie insolvent.' [911]

Accordingly, given the strict application of the case law concerning this defence, it is apparent that from the time new and former directors of a company come under a relevant obligation under section 269-15 of the TAA 1953, they will need to actively take steps to ensure that the company is placed into voluntary administration or wound up in order to escape liability.

[911] Ibid 158.

Defence Specific to Penalty Related to SGC

Thirdly, as a result of the 2012 amendments, section 269-35(3A) of the TAA 1953 provides an additional defence in the proceedings against a director if the company applied the relevant legislation in a particular way that was 'reasonably arguable' in regards to a SGC.[912] The term 'reasonably arguable' is defined in section 995-1(1) of the ITAA 1936 to have the meaning given by section 284-15 of Schedule 1 to the TAA 1953. A matter is reasonably arguable 'if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect'.[913]

The Commissioner's Practice Statement provides that this definition is a suitable standard for the purposes of the defence.[914] Exercising reasonable care means making a reasonable attempt to comply with the relevant law. The effort required is one commensurate with all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skill.[915] Accordingly, this defence is most likely to be relied upon by a director in those cases where there may be

[912] TAA 1953 s 978-025.
[913] TAA 1953 section 284-15.
[914] ATO PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 64. For further discussion on the meaning of 'reasonably arguable' refer to ATO, Miscellaneous Taxation Ruling MT 2008/2 Shortfall Penalties: Administrative Penalty for Taking a Position that is Not Reasonably Arguable.
[915] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 65; for further discussion on the meaning of 'reasonable care' refer to ATO, Miscellaneous Taxation Ruling MT 2008/1 *Penalty Relating to Statements: Meaning of Reasonable Care, Recklessness and Intentional Disregard*.

uncertainty about superannuation guarantee liabilities, in respect of whether particular workers are entitled to superannuation.[916]

Section 1318 of the Corporations Act

Section 1318 of the Corporations Act gives any court the power to make orders relieving a person from liability with respect to actual or prospective claims made in civil proceedings in respect of 'negligence, default, breach of trust or breach of duty'.[917] Section 1318 of the Corporations Act does not apply to an obligation or liability of a director under the director penalty provisions of the TAA 1953.[918] Accordingly, a director cannot be relieved from an obligation or liability under Division 269 of the TAA 1953 on the grounds of honest and reasonable conduct.[919]

Estoppel

Finally, it is possible for a director to raise a defence of estoppel. In *FCT v Winters* two directors were successful in arguing that summary judgement should not have been made against them on the basis that during negotiations with the ATO after receiving the DPN, they had been given reason to believe that time for compliance with the DPN would be extended.[920] They argued that they had therefore been induced not to appoint an administrator within the 14 day period of the notice and

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[916] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 63.
[917] Corporations Act s1318.
[918] TAA 1953 s 269-35(5);
DCT v Dick (2007) 67 ATR 762 held that section 1318 of the Corporations Act does not apply to penalties payable pursuant to Divs 8 and 9 of the ITAA 1936. This case has been legislated in TAA 1953 s 269-35(5).
[919] Ibid; Also see Corporations Act s588FGA(2); *Federal Commissioner of Taxation v Paditham* [2010] FCA 334.
[920] (1997) 97 ATC 4967.

that the Commissioner should be prevented from taking advantage of that failure (this period has been extended to 30 days under section 269-20(3) of the TAA 1953). In giving leave to the directors to defend, Moynihan J took the view that, depending on the resolution of factual issues in their favour, the defendants were capable of making out the elements founding an estoppel.[921]

However, this case can be considered an exception and can be contrasted with the large volume of cases where directors have been unsuccessful in establishing this defence.[922] For example, in the case of *DCT v Roche*, the Court held that the elements of an estoppel by representation could not be made out because the DCT had expressly rejected the director's payment proposal relating to the DPN.[923]

Effect of Director Paying Penalty or Company Discharging Liability and Director's Rights of Indemnity and Contribution

The DPN liabilities of directors are parallel liabilities and the Commissioner may seek from any one or more of the directors for the sum up to a total amount of the company liabilities.[924] Before determining which director or directors to pursue, the Commissioner will have regard to a number of factors, including each director's capacity to pay and the relative merits of any defences that may be available to them.[925] If an amount is paid or applied at a particular time towards discharging a

[921] Also see the recent case of *DCT v Roget [No 2]* [2014] WADC 25 where the Court held that the defence of estoppel raised by the defendant was a matter which should proceed to trial.
[922] See for example *DCT v Coco* (2003) 179 FLR 362 in which the director's argument that he did not receive the DPN was unsuccessful.
[923] [2013] WASC 302.
[924] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 67.
[925] Ibid.

company's liability under its obligation to pay an amount to the Commissioner on the due day, each director's liability to pay a penalty under Division 269 of the TAA 1953 in relation to the company's liability, if still in existence at that time, is discharged to the extent of the amount so paid or applied.[926] Further, a director who pays a penalty has the same rights, by way of indemnity, subrogation, contribution or otherwise, against the company or anyone else, as if the director made the payment under a guarantee of the company's liability.[927]

Corporate Insolvency Tax Framework

The second part of this chapter will consider how the director penalty regime impacts upon the criteria within the Framework. That is, does the director penalty regime achieve fiscal adequacy, promote corporate rescue and satisfy the socio-economic ideals of equity, efficiency and simplicity?

Fiscal Adequacy

To the extent that the government requires tax revenues in order to carry on its functions, its exposure to insolvency risk of taxpayers should be minimised.[928] The director penalty provisions in the Corporations Act were initially enacted to limit the Commissioner's exposure to insolvency risk. In that regard, the director penalty regime was introduced as a substitute for the Commissioner's priority. According to the Second Reading Speech of Senator McMullan in 1993, when introducing the new director penalty regime, any loss of revenue from abolishing the

[926] TAA 1953 s 269-40(2).
[927] TAA 1953 s 269-45.
[928] Shu-Yi Oei, 'Taxing Bankrupts' (2014) 55 *Boston College Law Review* 7.

Commissioner's priority was to be offset by the revenue recovered under the new director penalty regime.[929]

The director penalty regime allows for earlier intervention than under the Commissioner's former statutory priority as the director penalty regime does not rely on a company being placed into some form of external administration before the Commissioner can collect unremitted amounts. An early sign of insolvency in a company is that the company is living on the false reserves of non-remitted PAYG withholdings.[930] The Commissioner is in the position where he can act to collect unremitted PAYG and SCG liabilities at any point after he has notice of the failure to remit those amounts. Accordingly, the Commissioner can act to protect the revenue at an earlier stage when PAYG withholdings are relatively low and directors' liabilities are correspondingly so. Further, as a result of the 2012 amendments, if the PAYG withholding or SGC liability is not reported within three months of the due date for lodging a return, then remission of the penalty can only occur if payment is made.[931] These provisions clearly serve a revenue purpose for the government.

The 2012 amendments to the director penalty provisions were aimed at addressing the mounting revenue losses caused by phoenix activity in Australia.[932] One recent

[929] Australian Senate, *Senate Weekly Hansard No 3* (1993) 880.
[930] *DCT v George* (2002) 55 NSWLR 511 at 520, an 'early sign of problems in a company is its living on the false reserves of non-remitted deductions from employees' wages'.
[931] TAA 1953 s 269-30(2).
[932] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 5–6; Bill Shorten, *Protecting Employee Super and Strengthening the Obligations of Company Directors*, Media Release, No 138, October 2011.

study estimated the cost of phoenix activities (across all industries) to be between $1.79 billion and $3.19 billion per annum.[933]

The ATO considers illegal phoenix activity to be a 'serious threat to the integrity of the tax and superannuation systems' and a 'serious financial crime'.[934] The ATO's 2013-2014 Annual Report states that *'*we continued to target fraudulent phoenix activity as part of a whole-of-government strategy. We aim to maintain a level playing field for honest businesses, prevent ongoing revenue loss and support our law enforcement partners*'.*[935] In 2013–14, the ATO conducted over 270 reviews and audits resulting in $76.7 million in liabilities and cash collections of $12.3 million. In addition, the ATO undertook over 1,500 reviews and audits of property developers, with many also showing signs of fraudulent phoenix behaviour.[936]

Further, if phoenix activities are not dealt with by the imposition of harsh penalties, this can have a broader impact on tax compliance.[937] In that regard, the literature

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[933] PricewaterhouseCoopers, *Phoenix Activity: Sizing the Problem and Matching Solutions,* Prepared for the Fair Work Ombudsman (2012) iii.
[934] In the ATO's submission to Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015) 63.
[935] ATO, *Annual Report 2013-14* (2014) 62.
[936] Ibid.
[937] Raymond Fisman and Shang-Jin Wei, 'Tax Rates and Tax Evasion: Evidence from "Missing Imports" in China', (2004) 112 *Journal of Political Economy* 471; Basil Dalamagas, 'A Dynamic Approach to Tax Evasion' (2011) 39 *Public Finance Review* 309, 310; Cynthia Coleman and Lynne Freeman, 'Cultural Foundations of Taxpayer Attitudes to Voluntary Compliance' (1997) 13 *Australian Tax Forum* 311–336; Benno Torgler and Freidrich Schneider, 'The Impact of Tax Morale and Institutional Quality on the Shadow Economy' (2009) 30 *Journal of Economic Psychology* 228–245; Benno Torgler, 'Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments' (2002) 16 *Journal of Economic Surveys* 657–683; Benno Torgler, *'Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis'* (Cheltenham: Edward Elgar, 2007); James Alm and Benno Torgler, 'Culture differences and tax morale in the US and in Europe' (2006) 27 *Journal of Economic Psychology* 224–246; James Alm and Benno Torgler, 'Do ethics matter? Tax compliance and morality' (2011) 101 *Journal of Business Ethics* 635–651. Jeff Pope and Margaret A McKerchar, 'Understanding Tax Morale and Its Effect on Individual Taxpayer Compliance' (2011) 5 *British Tax Review Journal* 587–601.

suggests that the perceived level of tax evasion by other taxpayers is one of the factors that can cause taxpayers to be less likely to comply with their tax obligations.[938] This may lead to decreased tax collections due to impacts on taxpayer morale and propensity to comply which could potentially undermine the integrity of Australia's tax system.[939] Accordingly, it is clear that phoenix activities present a significant risk to achieving the fiscal adequacy criterion.

The 2012 amendments to the director penalty provisions have broadened the operation of the director penalty regime to all directors, not only those engaged in phoenix activities, making it easier for the Commissioner to pursue directors who cause the company to fall short of its PAYG withholding and SGC liabilities. This is likely to lead to an increase in revenue collections and mitigates some of the Commissioner's exposure to insolvency risk.

There is scope to further mitigate the Commissioner's exposure to insolvency risk of taxpayers. For example, the Proposals Paper raised the idea of extending the director penalty regime to Goods and Services Tax (GST) and other tax liabilities.[940] While the extension of the director penalty regime to GST and other tax liabilities would serve a revenue purpose, it was not adopted by the then Government. Further, expanding the director penalty regime in this manner would be contrary to the approach taken by the Australian Law Reform

[938] Ibid.
[939] Ibid.
[940] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 14. Matthew Broderick predicts that '[o]ne would expect phoenix entities (and directors) with a proven track record in unremitted PAYG tax, GST and/or unpaid superannuation to be the subject of security notices to be issued by the Commissioner in the not too distant future' in Matthew Broderick, 'Legislative change to director penalty notices and security for tax payments' (2011) 40 *Australian Tax Review* 60, 64.

Commission, English Cork Committee and the New Zealand Law Commission which all made the distinction between a claim based on the debtor's personal tax liability versus a claim based on a debtor's obligation to remit funds that have been withheld by the debtor to meet the tax liabilities of third parties, which are essentially held on trust.[941] In that regard, it has been argued that PAYE withheld amounts which are held on trust should be treated as a special class of tax debts as a failure to prioritise them in this manner will result in the general unsecured creditors receiving a windfall gain at the expense of the Commissioner who will be disenfranchised.[942] However, extending the director penalty regime to GST and other tax liabilities such as indirect tax liabilities and a company's own income tax liability would give the Commissioner a priority against employees and other creditors, which is clearly contrary to the original policy of removing the Commissioner's priority in a corporate insolvency.[943] Whilst GST amounts are held on trust in a similar manner to PAYG withholding amounts, the IGT makes a

[941] Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 300 where one of the arguments put in favour of tax priority was that 'it would be contrary to public policy to allow a person authorised to make deductions to use the money deducted to meet ordinary trade debts'; United Kingdom, Review Committee on Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558, para 1418 that a measure of Crown preference is justified in those cases where the Crown's claim for money is 'collected by the debtor, whether by deduction or charge, and for which the debtor is accountable to the Crown; the debtor is to be regarded as a tax collector rather than a taxpayer. Unless some measure of priority were accorded to the Crown for moneys collected on its behalf, or they were to be regarded as impressed with a trust, they would go to swell the insolvents estate to the advantage of the general body of creditors. We cannot think it right that statutory provisions enacted for the more convenient collection of the revenue should enure to the benefit of private creditors'; New Zealand, New Zealand Law Commission, *Priority Debts in the Distribution of Insolvent Estates*, Study Paper 2 (1999) 31 which states that these debts 'represent monies payable by the debtor to the Commissioner on behalf of another person. Thus, it is argued that there is an analogy with the law of trusts so that the debts should be afforded priority even though the monies may have been mingled with other fungibles, and are therefore no longer traceable.'

[942] Ibid.

[943] IGT, *'Debt Collection, A Report to the Assistant Treasurer'* (2015) 107.

distinction between the two, commenting that it is uncertain whether 'the broader public would consider GST to be of the same importance as employee entitlements'.[944] Against this view, the recent Senate Economics References Committee Report on Insolvency in the Australian construction industry was concerned that as a result of the regime failing to cover GST liabilities, unscrupulous property developers are able to intentionally avoid their GST obligations.[945] The Committee has called for further consideration on this point to be conducted by the Legislative and Governance Forum for Corporations.[946]

While there is scope to extend the director penalty regime further, the current regime clearly serves a revenue purpose. This is particularly the case following the 2012 amendments that have expanded the regime.

Corporate Rescue

Unlike many of the Commissioner's powers which predominantly serve a revenue purpose (for example, those powers that were discussed in Chapter 6 and later in Chapter 8 of this thesis), the director penalty regime has a much closer connection with corporate insolvency law. The connection between tax and corporate insolvency law in relation to the director penalty regime was considered in *DCT v Dick*.[947] In that case, Spigelman CJ noted that the former Divisions 8 and 9 of the ITAA 1936 (now Divisions 268 (Estimates and recovery of PAYG withholding

[944] Ibid.
[945] Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015) 118.
[946] Ibid 118-119; The Legislative and Governance Forum for Corporations is the body with oversight of corporate and financial services regulation.
[947] (2007) 67 ATR 762.

liabilities) and 269 of the TAA 1953) are 'one part of a set of interrelated provisions which could be said to simultaneously serve both revenue and corporations law purposes.'[948] Spigelman CJ discussed the connection between these Divisions and corporate law, describing the connection starting with the removal of the Commissioner's priority for tax that was substituted by two sets of provisions, namely Pt 5.7B of the Corporations Act and Divisions 8 and 9 of the ITAA 1936.[949] Santow JA noted that these two sets of provisions 'reach into a core area concerned with corporations, namely their liquidation or administration'.[950] His Honour went on to say that:[951]

> Though these matters are directed to discharging fiscal obligations they:
>
> (a) are imposed on directors as such;
>
> (b) replace the Tax Commissioner's historical priority for tax; and
>
> (c) substitute a scheme for accelerated collection of PAYG amounts, which, though it is found in income tax legislation, has a direct connection with the liquidation or administration of companies.

The New South Wales Court of Appeal considered the relevance of this connection between tax law and corporate insolvency law and determined that a core responsibility of a Board's oversight includes the wider statutory obligation to collect and account for corporate employee taxes.[952] This is achieved by imposing strict obligations on directors to cause their company to comply with these tax

[948] *DCT v Dick* (2007) 67 ATR 762, 393.
[949] Ibid.
[950] Ibid 406.
[951] Ibid.
[952] Ibid 409.

obligations or face personal penalty.[953] In doing this, Santow JA commented that:[954]

> [T]ax legislation reaches into core corporate areas of liquidation and the related status of administration. Thus neglect of that statutory obligation can put the corporation at risk of its demise. These PAYG obligations of directors are no less obligations of a director qua director in both an individual and collective board sense and no less capable of giving rise to default or breach of duty than other corporate statutory obligations. They arise directly under the ITAA and indirectly in avoiding endangering the company by their breach. A breach of the tax obligation is capable of giving rise to a parallel breach of the core duty of care and diligence if directors expose their company carelessly to liquidation or administration by reason of their permitting neglect of the company's PAYG obligations.

This close connection between the director penalty regime and insolvency can be demonstrated by the high rate of insolvency following the issuing of a DPN.[955] Between 2011 to 2012 and 2013 to 2014, the ATO issued over 27,000 DPNs primarily to directors of small businesses and approximately 21 per cent of these taxpayers became insolvent following the issuing of a DPN.[956] Approximately 21 per cent of large businesses also became insolvent during that period following the issue of a DPN.[957]

A taxpayer's complacency in relation to complying with their tax obligations is a common factor of poor business conduct and of pending business insolvency.[958] In that regard, directors who neglect their tax obligations put the company at risk and mechanisms must be put in place to prevent this from occurring. The director penalty regime provides such a mechanism by making directors personally liable

[953] Ibid.
[954] Ibid.
[955] IGT, *Debt Collection, A Report to the Assistant Treasurer* (2015) 105.
[956] Ibid.
[957] Ibid.
[958] ASIC, *Duty to Prevent Insolvent Trading: Guide for Directors*, Regulatory Guide RG217 (2010) 2, 21.

for such amounts. Further, it encourages directors to confront solvency problems earlier and to ensure that steps are taken expeditiously to prevent a company continuing to incur debts when in financial difficulty. The Harmer Report stated:[959]

> An ordered form of administration of the affairs of an insolvent person is at the centre of insolvency law — whether, in the case of an insolvent company, that law offers the prospect of a winding up or continuation of the corporate business. This approach is similar to that taken by insolvency law inquiry bodies in many overseas countries, such as US, Canada, UK and some of the European nations. It also requires legislation to encourage directors to take early and orderly steps to deal with an existing or impending state of insolvency. The Commission's recommendations in respect of potential director liability for the debts of an insolvent company may provide such encouragement... [T]he aim is to encourage early positive action to deal with insolvency.

If the director penalty regime was not in place, directors of a company would be more likely to continue to trade on false reserves, leading to the demise of the company to a point where there is no chance of achieving corporate rescue post insolvency.[960] Accordingly, the director penalty regime allows for early intervention by the Commissioner and is likely to result in the directors of a company acting promptly to place the company into external administration, thereby increasing any prospects of corporate rescue post insolvency.

While the director penalty regime is aimed at achieving early intervention, the IGT has recommended that ATO intervention come at an earlier point and has identified the 'critical period' as the period between where lodgement/payment is

[959] Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* (1988) 53.
[960] As put by Stephen Mullette, 'the purpose of the DPN scheme is to ensure that corporate solvency issues were addressed earlier and to prevent the escalation of debts' in Stephen Mullette, 'Secret service' (2008) 16 *Insolvency Law Journal* 195, 206. Further, the Commissioner 'recognises that the prompt dispatch of DPNs can encourage directors to address a company's financial difficulties before they become insurmountable'; see ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 47.

not made and when the ATO subsequently issues a DPN.[961] The IGT is of the view that 'during this period, the ATO needs to consider interacting with directors in a 'gentler' way by, for example, also sending directors the lodgement/payment reminders, offers of payment arrangements or promptings to seek professional advice if the business does not appear viable to the ATO'.[962] The IGT Review reports that 'such actions may prompt directors to take earlier remedial action which would improve the chances of a business restructuring and avoiding insolvency'.[963]

Accordingly, the preceding discussion of the director penalty regime demonstrates that the regime has greater alignment with corporate insolvency law (and therefore corporate rescue objectives) than many of the other enforcement powers available to the Commissioner to enforce an outstanding tax debt. In particular, the director penalty regime fosters good corporate governance which is fundamental to achieving successful corporate rescue. However, there is a period prior to the issue of a DPN where the ATO could be more engaged with the corporate tax debtor which would further improve the prospects of a corporate tax debtor achieving corporate rescue post-insolvency.

Equity

This chapter has highlighted the broad scope of the director penalty regime and the onerous obligations that it imposes upon the directors of a company. The director penalty regime applies to new and retiring directors and to 'silent' directors who are commonly spouses or adult children of the taxpayer who do not understand

[961] IGT, *Debt Collection, A Report to the Assistant Treasurer* (2015) 107.
[962] Ibid.
[963] Ibid.

their obligations. In the case of a company which cannot meet its PAYG withholding and SGC liabilities, the time given to directors to arrive at an agreement with the Commissioner, appoint an administrator, or commence the winding up of the company is very short. As a result of the 2012 amendments, if the PAYG withholding or SGC liability is not reported within three months of the due date for lodging return then remission of the penalty relating to the unreported amount will only occur if payment is made. Further, the limited defences have been applied very strictly by the courts, making it almost impossible for a director to escape liability by relying on a defence.

Adding to the equity considerations above, is that the ATO has removed safeguards for the non–service of demands, requiring only notices to be posted but not necessarily received.[964] An internal ATO quality report on DPNs found that in 50 per cent of DPNs sampled, actions did not meet the ATO's requirements in relation to 'appropriate interaction'. [965] One of the main reasons for this was that an alternative or more recent address of a director was available to the ATO and a copy of the DPN was not sent to that address despite staff procedures requiring a photocopy of the DPN to be sent to the alternative address.[966] While the notice requirement is an important mechanism for the ATO to protect the revenue in cases where directors cannot be located, it makes it impossible for those diligent directors to take remedial action if they are unaware of the proposed action.

[964] TAA 1953 s 269-25(4); *Roche v DCT* [2014] WASCA 194, 279.
[965] IGT, *Debt Collection, A Report to the Assistant Treasurer* (2015) 106.
[966] Ibid.

While the director penalty regime can be considered harsh in its operation, the consequences to directors who fail to meet their tax obligations must be balanced against the need to protect all stakeholders impacted by a company's insolvency. This approach is consistent with the definition of equity in the Framework that considers all stakeholders involved in the insolvency when measuring whether this criterion has been satisfied. The ATO has been identified as one such stakeholder. The director penalty regime also protects employees by ensuring that amounts withheld from their pay in relation to their tax liability and superannuation can be recovered from company directors where those amounts were not remitted to the ATO.[967] Further, it encourages directors to take early action, prior to a company becoming hopelessly insolvent so that employees do not lose their entitlements such as their accrued annual and long service leave entitlements, in addition to wages, redundancy and pay in lieu of notice.[968] If employees were not afforded this protection under the director penalty regime, deficiencies in retirement savings would result, thereby threatening the wider economy.[969]

The director penalty regime protects unsecured trade creditors who may experience their own financial crises as a result of the directors' failure to meet the company's tax obligations. State revenue authorities are protected as they will lose payroll tax revenue. Competitors are also protected by the director penalty regime. In that regard, the Royal Commission into the Building and Construction Industry produced a lengthy report containing many recommendations, including a chapter

[967] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) para 2.
[968] Ibid.
[969] Ibid.

devoted to phoenix companies.[970] Among its many adverse consequences, Commissioner Cole noted that 'phoenix behaviour even affects competitors. Companies that fail to pay taxes, superannuation contributions and employee entitlements can undercut prices in tenders made by law-abiding companies, which may be induced to act in a similar manner if phoenix activity is not detected and prosecuted.'[971]

While the protection of these stakeholders from directors that engage in phoenix activity is paramount, the equity argument becomes more complex in relation to the operation of the harsh director penalty regime to all other 'innocent' directors. One of the opposition's main objections to the introduction of the phoenixing legislation was that it had the potential to affect all companies rather than those actually engaged in improper phoenix activity.[972] This concern becomes particularly relevant given the current economic climate where entrepreneurship and responsible risk taking need to be encouraged.[973] Equally, there are considerable pressures placed on the revenue caused by the current economic environment with

[970] Royal Commission into the Building and Construction Industry, *Final Report* (2003) Vol 8 Ch 12.
971. This concern was raised in NSW Government, *Inquiry into Construction Industry Insolvency in NSW*, Final Report (2013) 33 which comments 'Not only could the worst offenders in the industry simply close up shop one day, leaving any number and amount of debts unpaid, and opening up the next day under a different trading name, these were the same operators who were gaining an unfair competitive advantage by undercutting their rivals In the bid process'; Also see Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015) 73 refers to a number of submissions which stated that 'phoenix companies are awarded projects through "net-of-tax-tendering": that is where companies tender quotes calculated on the basis that they will not pay taxes'. A considerable amount of anecdotal evidence of this practice is given in this Report; Adele Ferguson, 'Phoenix directors are feeding off failure', *Sydney Morning Herald*, 14 November 2012.
[972] Commonwealth, Parliamentary Debates, *Senate*, 9 May 2012, 2884 (Senator Mathias Cormann) and for this reason it opposed its passage in the House of Representatives and the Senate.
[973] Glenn Stevens, 'Issues in economic policy' (Speech delivered at the Anika Foundation Luncheon, Sydney, 22 July 2015).

the ATO's level of collectable debt becoming a major problem and coupled with this, the importance from a policy perspective of ensuring that PAYG withholding and SGC liabilities are paid.[974] This makes achieving equity complex as a balance must be struck between encouraging entrepreneurship so that the economy can be stimulated and grow with the insolvency risks to other stakeholders.

Arguably, the director penalty regime achieves the right balance. In that regard, if directors act in the manner expected of them in meeting their PAYG withholding and SGC obligations, they will not be impacted as they will have time to place the company into external administration and the penalty will be remitted. Accordingly, the regime is unlikely to penalise directors who actively participate in the management of the company and engage in sound corporate governance practices. From a policy perspective, this is appropriate and the regime against directors is fair.

If the current director penalty regime is considered to align with the broader concepts of equity within the Framework, the argument can then be made that the regime could be more equitable by making other stakeholders that are involved in the insolvency liable for their actions. For example, perhaps the regime should extend to the secured lenders and shareholders of the company that may have profited from the operations of the company over a period of time prior to the company becoming insolvent. This is particularly so where the financial and other costs (i.e. environmental, public health) associated with the insolvency are

[974] IGT, *Debt Collection, A Report to the Assistant Treasurer* (2015) ix; IGT, *Review into the ATO's administration of the Superannuation Guarantee Charge* (2010) 85-89.

considerable. Any reform of this nature would reshape the fundamental principles of corporate law and would involve considerable public consultation. Accordingly, this argument is largely philosophical and will not be explored further.

Efficiency

There are a number of efficiencies associated with the director penalty regime that have been discussed in this chapter, including there being no need for court involvement to recover unremitted PAYG withholding and SGC liabilities unless a defence is raised, the very short time frame in which directors can act, and the use of estimates of unpaid PAYG withholding liabilities as a basis for the commencement of recovery action.

Equally, the Proposals Paper highlighted that there are also a number of inefficiencies with the current director penalty regime. The Proposals Paper commented that issuing DPNs to crystallise a director's debt was highly resource-intensive for the ATO, resulting in directors escaping liability.[975] The Proposals Paper noted that the resource-intensive nature of the director penalty regime resulted in DPNs being issued to only a small percentage of directors who would otherwise be liable under the regime and in many cases there was a 6-12 month delay in issuing a DPN after a penalty was first incurred.[976]

One option for reform discussed in the Proposals Paper aimed at creating greater efficiencies is that the director penalty regime be automated, so that the regime

[975] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 5-6.
[976] Ibid 8.

will automatically apply a parallel liability to directors of companies whose PAYG withholding liability remains unpaid for a period of time (the Proposals Paper suggests a three month period).[977] The 2012 amendments partially automated the director penalty regime, but only in respect of amounts of unremitted PAYG withholding and SCG liability not reported within three months of the due date for lodging the return.

The Proposals Paper recommended that automation should go further in that it should also apply if payment is not made during the prescribed period of time (i.e. three months).[978] Automating the regime in this manner would create efficiencies as it would limit the advantage gained by not remitting PAYG withholding and SGC liabilities to the prescribed period of time, making it easier and more cost effective for the ATO to administer the regime.[979] The ATO holds the view that being able to intervene in real time or in a timely manner would allow it to become more successful in addressing phoenix activities before the redistribution of profits occurs.[980]

However, as noted in the Proposals Paper, 'automating director penalties creates a risk of impacting on directors who are not engaged in fraudulent phoenix activity and in these cases recognises the possible need for limitations on the operations of

[977] Ibid 13. The Insolvency Practitioners Association of Australia supports automation, noting it 'will encourage directors to address solvency issues earlier, and treat them more seriously' in Insolvency Practitioners Association of Australia, Submission to the Standing Committee of Economics, *Tax Laws Amendment (2011 Measures No.8) Bill 2011 and the Pay As You Go Withholding Non-compliance Tax Bill 2011* (2011) 2.
[978] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 13.
[979] Ibid.
[980] Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015) 6 making reference to an ATO submission.

an automated director penalty regime'.[981] Honest directors who are not engaged in phoenix activities must be given a period of time to address the issues that caused the non-payment of liabilities. This will involve ascertaining whether the non-payment of liabilities relates to short term cash flow issues or to fundamental solvency issues which may involve the engagement of an expert in insolvency, external to the corporation and perhaps placing the company into liquidation or administration if appropriate. This would be consistent with the original policy intent of the regime of providing an incentive for all directors to ensure that their company complies with their obligations.[982] If a liability remains unpaid after this period, a director should not be able to avoid a penalty.

The Commonwealth Ombudsman has recommended that if automated DPNs are introduced, there must be a mechanism 'for the ATO to consider cases where the liability is disputed and to exercise discretion to remove the penalty in unexpected and deserving cases and to take into account the Australian Government's Better Practice Guide to Automated Assistance in Administrative Decision-Making'.[983]

The Proposals Paper recommended retaining the current director penalty regime alongside the automated regime which 'would allow an additional mechanism to crystallise a director's liability in cases where the Commissioner wants to take action within three months of a liability being incurred.[984] For example, in instances

[981] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 13.
[982] Australia, *Senate Weekly Hansard No 3* (1993) 880. Also see, *DCT v Falzon* [2008] QCA 327 at 14-15.
[983] Commonwealth Ombudsman, *Commonwealth and Taxation Ombudsman, Comments on Action against Fraudulent Phoenix Activity Proposals Paper* (2010).
[984] Australian Treasury, *Action Against Fraudulent Phoenix Activity* (2009) 13.

where the ATO has identified a particular director who wilfully continues to disregard the company's PAYG withholding or SCG liabilities, the DPN can be issued at any time following the end of the due day for lodging a return'.[985]

As discussed above, there are considerable efficiencies with the director penalty regime which has become even more efficient as a result of partial automation of the regime post the 2012 amendments. As such, the regime is achieving the efficiency criterion within the Framework. While there is scope to create further efficiencies through legislating for further automation, any further automation needs to be balanced with the need to give directors adequate time to respond to any solvency issues so as not to impact upon the other criteria in the Framework.

Simplicity

This chapter has highlighted the complex nature of the director penalty regime, the complexities involved with its administration and the added layer of complexity that has resulted from the 2012 amendments. In order to make the regime simpler, mechanisms could be put in place to educate directors as to their obligations and the failure to meet them.

The IGT has made a number of recommendations in relation to DPNs in a recent review centred on achieving greater engagement with company directors and providing directors with educative materials so that they are aware of their legal obligations.[986] Many stakeholders believe that an education program could be run

[985] Ibid.
[986] Commonwealth, Parliamentary Debates, *Senate*, 9 May 2012, 2884 (Senator Mathias Cormann) and for this reason it opposed its passage in the House of Representatives and the Senate, 108.

to help small business owners and other directors, who may invariably be family members or silent directors, become aware of their legal responsibilities.[987]

In this regard, the IGT has recommended that the ATO explore opportunities with other agencies to jointly develop educative materials.[988] Whilst the ATO has commenced work with ASIC and State revenue agencies to provide information on the director penalty regime via each agency's website, one recommendation by the IGT is that the ATO consider working with other agencies to jointly develop a more integrated suite of materials on a broader range of issues for small business owners.[989]

While these initiatives will assist directors to gain awareness as to the significant liability they could face if they fail to meet their PAYG withholding and SGC obligations, it will be difficult to achieve the level of engagement required from directors in small businesses who are time poor, and from silent directors who have not taken interest in the affairs of the business and who are therefore unlikely to be interested in any educative materials available.

Conclusion

This chapter has considered the operation of the director penalty regime under Division 269 to Schedule 1 of the TAA 1953 which empowers the Commissioner to take action against an insolvent company's directors to recover outstanding tax debts of a company. The chapter began by considering the historical background

[987] Ibid 72.
[988] Ibid Chapter 2, Recommendation 2.4.
[989] Ibid.

to the director penalty regime which was introduced as a substitute for the Commissioner's priority and was aimed at encouraging directors to take early positive action to deal with insolvency. Accordingly, the director penalty regime was a product of both tax law and insolvency law coming together to develop an enforcement mechanism equipped to achieve the key objectives of both areas of law. This can be contrasted with the enforcement powers of the Commissioner discussed in Chapter 6, where the tax law has been enacted with no regard to the insolvency process, leading to the key objectives of insolvency law being displaced by the fiscal adequacy criterion of tax law.

The discussion of how the director penalty regime impacts upon each of the criteria within the Framework highlights that the director penalty regime is achieving the fiscal adequacy, corporate rescue, efficiency and equity criteria within the Framework, indicating that these provisions in the tax law interrelate and align with insolvency law more harmoniously than the other powers of the Commissioner to recover outstanding tax debts that have been examined in this thesis. While there is scope to extend the regime further, perhaps the right balance has already been achieved. In that regard, although the provisions operate in a harsh manner, they encourage early intervention by directors to take action to resolve cash flow problems as soon as they arise, encourage directors to actively participate in the management of the company and therefore foster a culture of good corporate governance, and mitigate the insolvency risk to other stakeholders who would be

adversely impacted by the demise of the company.[990] There is however considerable opportunity to put mechanisms in place to educate directors as to their obligations and of the consequences of failing to meet them which would make the regime simpler.

The next chapter will explore the Commissioner's right as a creditor to commence liquidation proceedings when dealing with a tax debtor that is approaching insolvency or is insolvent.

[990] Senate, Economics References Committee, '*I just want to be paid', Insolvency in the Australian construction industry* (2015) xxi which commented '[e]arly detection and intervention is crucial to preventing companies in financial distress from either entering insolvency, or continuing to raise debts before eventually collapsing.'

Chapter 8 - Recourse Against the Insolvent Company to Commence Liquidation Proceedings: The Commissioner's Power to Issue Statutory Demand Notices

Introduction

The previous chapter considered the power of the Commissioner to take recourse against an insolvent company's directors to recover outstanding tax debts of a company under Division 269 to Schedule 1 of the TAA 1953. The director penalty regime was a product of both tax law and insolvency law coming together to develop an enforcement mechanism equipped to achieve the key objectives of both areas of law. Accordingly, an assessment of this power of the Commissioner against the Framework evidenced that there was considerable alignment between tax law and insolvency law with respect to the director penalty regime.

This chapter examines the Commissioner's right as a creditor to commence liquidation proceedings when dealing with a tax debtor that is approaching insolvency or that is insolvent, by issuing a statutory demand notice under section 459E of the Corporations Act. In particular, this chapter argues that the Commissioner's power to serve a company with a statutory demand has regrettable consequences when it comes to attempts to implement corporate rescue and does not adequately address the protection of taxpayers against the impact of erroneous assessments. This has significant implications for achieving the corporate rescue and equity criteria within the Framework resulting in considerable

disharmony at the intersection of tax law and insolvency law. The chapter suggests areas for reform and considers directions for future research and action.

Creditors' Statutory Demand

The Corporations Act allows creditors who are owed more than the statutory minimum of $2,000 to deliver to a company what is known as a Creditor's Statutory Demand. A Creditor's Statutory Demand must be in the prescribed form and accompanied by an affidavit from or on behalf of the creditor verifying that the debt is due and owing.[991] A company that is served with a Creditor's Statutory Demand has a period of 21 days to either pay the amount demanded or bring an application in the Supreme Court or Federal Court to have the Creditor's Statutory Demand set aside.[992] If the company does not comply with the demand, the company is deemed insolvent.[993] The company is then at a very real risk of a court later ordering a liquidator to be appointed to wind-up the company.

A company that is served with a Creditor's Statutory Demand may bring an application to set aside the Statutory Demand for a number of reasons, including:

- the company has a genuine dispute about the existence or amount of a debt to which the demand relates;[994]
- the company has an off-setting claim;[995]

[991] Corporations Act s 459E.
[992] Ibid.
[993] Corporations Act s459C(2)(a).
[994] Corporations Act s 459H(1)(a).
[995] Corporations Act s 459H(1)(b).

- there is a defect in the Creditor's Statutory Demand which causes substantial injustice to the company;[996] or

- there is some other reason why the demand should be set aside.[997]

The Decided Cases: A 'genuine dispute' About the Existence or Amount of a Debt

There are a number of authorities that have considered what constitutes a 'genuine dispute' about the existence or amount of a debt to which the demand relates. In that regard, the Full Federal Court in *Spencer Construction Pty Ltd v GAM Aldridge Pty Ltd*[998] stated that a dispute will be genuine if it is 'real and not spurious, hypothetical, illusory or misconceived.'[999] In the case of *TR Administration Pty Ltd v Frank Marchetti & Son Pty Ltd*[1000] it was held that 'no in depth examination or determination of the merits of the alleged dispute is necessary, or appropriate'.[1001] Accordingly, the threshold for demonstrating whether a genuine dispute exists is set very low for all creditors except the Commissioner which is expanded upon in the following discussion.

The leading authority in relation to how the statutory demand regime can be wielded by the Commissioner is the HCA decision of *DCT v Broadbeach Properties Pty Ltd.*[1002] In that case, four companies in the Howard Group were subject to an audit that resulted in the DCT issuing various GST and income tax assessments,

[996] Corporations Act s 459J(1)(a).
[997] Corporations Act s 459J(1)(b).
[998] (1997) 76 FCR 452.
[999] Ibid 464.
[1000] [2008] VSCA 70.
[1001] Ibid 57.
[1002] *DCT v Broadbeach Properties Pty Ltd* [2008] HCA 41.

declarations and penalty notices. The DCT then proceeded to issue statutory demand notices to each of the companies in the Howard Group with respect to these outstanding debts. At the time the statutory demands were issued, the companies stated that they disputed the tax liabilities and were intending to exercise their rights of appeal under Part IVC of the TAA 1953. Importantly, during the proceedings the DCT admitted that the Howard Group had advanced a reasonably arguable case at the Administrative Appeals Tribunal (AAT) that the tax debt was not owing. Each of the four entities comprising the Howard Group filed and served applications to set aside the statutory demands for payment of the assessed liabilities issued by the DCT.

At first instance, the matters were heard by the Supreme Court of Queensland and judgment was given in favour of the applicants such that the statutory demands were set aside. The DCT appealed to the Queensland Court of Appeal and the DCT's appeals were dismissed. The Court of Appeal found that, notwithstanding the operation and effect of sections 105-100 of the TAA 1953, section 177 of the ITAA 1936[1003] and sections 14ZZR[1004] and 14ZZM[1005] of the TAA 1953, the existence of a dispute pursuant to Part IVC of the TAA 1953 constituted a 'genuine dispute' for the purposes of section 459H of the Corporations Act. The Court of Appeal also

[1003] TAA 1953 s 105-100 and ITAA 1936 s 177 are the conclusive evidence provisions. ITAA 1936 s 177 is a conclusive evidence provision which applied to assessments of income tax. TAA 1953 section 105-100 was a conclusive evidence provision which covered GST assessments and declarations.

[1004] TAA 1953 s 14ZZM provides 'The fact that a review is pending in relation to a taxation decision does not in the meantime interfere with, or affect, the decision and any tax, additional tax or other amount may be recovered as if no review were pending.'

[1005] TAA 1953 s 14ZZM provides 'The fact that a review is pending in relation to a taxation decision does not in the meantime interfere with, or affect, the decision and any tax, additional tax or other amount may be recovered as if no review were pending.'

found that the trial judge had properly exercised his discretion pursuant to section 459J of the Corporations Act to set aside the DCT's demands on the basis of 'other reason'.

The DCT sought and obtained Special Leave to Appeal to the HCA from the Queensland Court of Appeal's judgment. The HCA allowed the DCT's appeals in full. In relation to whether there was a 'genuine dispute' (section 459H of the Corporations Act), it was held that:

- The long-standing legislative purpose of the conclusive evidence provisions (sections 177 of the ITAA 1936, and sections 105-100 and 298-30 of the TAA 1953) is to protect the interests of the revenue.[1006]

- 'Special status' and characteristics attach to tax debts which do not pertain to debts in the sense of general law.[1007]

- The production by the Commissioner of notices of assessment and GST declarations conclusively demonstrates that the amounts and particulars are correct (Sch 1, s 105-100 (now s 350-10) of the TAA 1953, and s 177(1) of the ITAA 1936). The provisions of the taxation laws creating these debts and providing for their recovery cannot be circumvented under 459G of the Corporations Act.[1008]

[1006] *DCT v Broadbeach Properties Pty Ltd* [2008] HCA 41, 44.
[1007] Ibid 51.
[1008] Ibid 57.

- Sections 14ZZM and 14ZZR of the TAA 1953 apply to the Statutory Demand procedure precluding a 'genuine dispute' under section 459H of the Corporations Act as to the existence and amount of tax debts.[1009]

- That upon the hearing of a winding up application, the court might properly have regard to whether the taxpayer had a 'reasonably arguable' case in pending proceedings in which it was objecting to the tax assessment. However, the existence of a 'reasonably arguable' case cannot be taken into account at the statutory demand stage.[1010]

- In relation to setting aside the statutory demand for 'other reason' (section 459J of the Corporations Act), it was held that the material considerations in determining whether to set aside a statutory demand under section 459J of the Corporations Act must include the legislative policy manifested in sections 14ZZM and 14ZZR of the TAA 1953. Accordingly the Court found that the exercise of the discretion by the Queensland Court of Appeal under section 459J of the Corporations Act had miscarried.[1011]

As a result of failing to comply with the statutory demand notices the companies comprising the Howard Group were presumed to be insolvent pursuant to section 459C(2)(a) of the Corporations Act. The companies were therefore put in a position where they could simply be wound up by the DCT. While it was held that upon the hearing of a winding up application the court might properly have regard to whether the taxpayer had a 'reasonably arguable' case in pending proceedings in

[1009] Ibid 58.
[1010] Ibid 62.
[1011] Ibid 61.

which it was objecting to the tax assessment, by that stage much damage would already have been done. In that regard, not only is the company at risk of a liquidator being appointed, but there are a number of other far reaching implications, including:

- if a company has entered into any loan agreements, it is likely that they will contain provisions which detail 'events of default' which may include the company being served with a statutory demand or if the company is subject to a winding up application. If this is the case, the lender may call up its outstanding loans or appoint its own external receivers and managers;
- the company will have to fund any winding up proceeding;
- the directors of the company will need to consider their risk of exposure to the provisions in the Corporations Act which makes them personally liable for trading whilst the company is presumed insolvent; and
- the company's creditors may be informed of the winding up application which may result in those creditors being apprehensive in relation to continuing to extend credit to the company.

The result of this decision appears unsatisfactory. Even though the Howard Group went through the proper appeals process to dispute the tax liabilities, the companies could not avoid the commencement of liquidation proceedings as they were deemed to be insolvent given they had failed to comply with the statutory demand notices.

The ATO has published a Decision Impact Statement in relation to this HCA decision.[1012] The Decision Impact Statement states that the ATO 'respectfully agrees with all aspects of the High Court's decision' and that '[t]he Commissioner will continue to use statutory demands in appropriate cases in accordance with the ATO Receivables Policy.'

The Decided Cases: The Court's Power to Exercise its Discretion for 'Some Other Reason'

HC Legal Pty Ltd v DCT[1013] is a decision of the Federal Court which, in addition to the 'genuine dispute' ground for setting aside a statutory demand, considered the Court's power to exercise its discretion under section 459J(1)(b) to set aside a Commissioner's statutory demand for 'some other reason'.

This case involved a law firm, Hambros and Cahill Lawyers (HC Legal), that entered into an unusual agreement to purchase exclusive rights to legally represent a third party and agreed to pay the third party $49.5 million including GST under a vendor finance agreement. The effect of the vendor finance agreement was that HC Legal did not need to advance any funds at the time. In early 2012, when HC Legal came to lodge its BAS for the last quarter in 2011, it stated it had made a capital purchase in the sum of $49.5 million in the last quarter of 2011 and claimed input tax credits from the Commissioner in the sum of $4.5 million for the GST paid on that

[1012] ATO, *Decision Impact Statement DCT v Broadbeach Properties Pty Ltd; DCT v MA Howard Racing Pty Ltd and DCT v Neutral Bay Pty Ltd ("Howard Group")*, issued 15 October 2008.
[1013] [2013] FCA 45.

purchase. After deductions for GST amounts it owed, it claimed $4,491,954 in input tax credits which the Commissioner then remitted to HC Legal.

There was no evidence as to what then happened to that money in the hands of HC Legal, but HC Legal's counsel informed the Court that it had been used to pay certain expenses of the firm, a deposit to purchase Seabrook Chambers in Melbourne, and the balance of $2 million each was distributed to the two directors, posted in the books as a loan, although each director had paid back $350,000 to HC Legal. Shortly thereafter the Commissioner froze HC Legal's bank accounts and moved to audit the firm.

In May 2011, following the audit, the Commissioner assessed HC Legal as liable to pay $4.5 million in GST. However, although the ATO's Running Balance Account (RBA) statement for the company showed that GST liability as relating to the last quarter of 2011, the notice of assessment referred to the first quarter of 2012. Under a separate notice with the correct tax period cited, there was also a penalty imposed of $2.5 million.

On 19 June 2012, HC Legal lodged its objection to the assessment and penalty. On 4 July 2012, the Commissioner served the statutory demand, seeking payment of $6.95 million, comprising $4.5 million in GST and $2.25 million in penalty and interest charges. On 11 September 2012, the Commissioner sent a letter enclosing a new and revised assessment to HC Legal, asserting the first notice had contained a typographical error and that the correct tax period was the last quarter of 2011. This was followed by an email from the Commissioner's office referring to the error in the first assessment.

HC Legal contended that there was a genuine dispute under section 459H of the Corporations Act in relation to the debt asserted by the Commissioner. Murphy J rejected this argument and held that 'HC Legal's contention raises a spurious rather than bona fide or real ground of dispute'. In reaching this conclusion, the Court relied on a number of legislative powers open to the Commissioner which provide that the production of a RBA statement and a notice of assessment are conclusive evidence that the amounts and particulars of the RBA statement and assessment are correct.[1014]

In the alternative HC Legal contended that the statutory demand should be set aside for 'some other reason' under section 459J of the Corporations Act. HC Legal based this upon the Commissioner's conduct, upon the fact that HC Legal had disputed the assessment by lodging an objection, and upon the contention that it had a reasonably arguable case on its objection. There are a number of authorities which have considered when it is appropriate for a court to exercise this discretion. Murphy J considered the Full Federal Court's decision in *Hoare Bros Pty Ltd v DCT*,[1015] where the Court observed that the discretion might be exercised where it is 'shown that the Commissioner's conduct was unconscionable, was an abuse of process, or had given rise to substantial injustice.'[1016] Murphy J expressed the view that he did not consider the Court in *Hoare Bros* was seeking to exhaustively set out the situations it comprehends. Murphy J also relied on the observation of the Queensland Court of Appeal in *Neutral Bay Pty Ltd v DCT* that it is open to a court

[1014] Ibid 37-41 relied on TAA 1953 ss 8AAZI, 8AAZH(1), 255-5, 255-1, 350-10.
[1015] (1995) 19 ACSR 125.
[1016] Ibid 139.

to conclude that there is reason to set aside a statutory demand without finding unconscionable conduct or unfairness on the part of the Commissioner. However, Murphy J qualified this observation in light of the comments of the HCA in *Broadbeach* which overturned the decision in *Neutral Bay*.[1017] Accordingly, there remains some contention as to whether it may be necessary to demonstrate that the Commissioner's conduct has given rise to substantial injustice.

HC Legal argued that the existence of proceedings disputing a tax assessment may be relevant to the exercise of the discretion.[1018] However, as Murphy J noted:

- In 2008 in Broadbeach, subsequent to the authorities HC Legal relied upon, the HCA observed that:[1019]

> [T]he hypothesis in the present appeals must be…that there is no "genuine dispute" within the meaning of s 459H(1). Both the primary judge and the Court of Appeal emphasised the importance of the disruption to taxpayers, their other creditors and contributories that would ensure from a winding up, together with the absence of any suggestion that the revenue would suffer actual prejudice if the Commissioner were left to other remedies to recover the tax debts. But these considerations are ordinary incidents of reliance by the Commissioner upon the statutory demand system….
>
> The "material considerations"…which are to be taken into account, on an application to set aside a statutory demand, when determining the existence of the necessary satisfaction for para (b) of s 459J(1) must include the legislative policy, manifested in ss 14ZZM and 14ZZR of the Administration Act, respecting the recovery of tax debts notwithstanding the pendency of Pt IVC proceedings.

[1017] [2013] FCA 45, 45.
[1018] Ibid 46.
[1019] *DCT v Broadbeach Pty Ltd* [2008] HCA 41, 60-61.

- Murphy J considered that the legislative policy in sections 14ZZM and 14ZZR is that tax assessments are to be paid, even though a review or appeal is 'on foot';[1020]

- Murphy J also pointed to the judgment of Olney J in *Kalis Nominees Pty Ltd v DCT* where Olney J with a tone of regret noted:[1021]

> The policy of the law would be defeated if a demand were set aside under s 459J(1)(b) simply because a review of an objection decision is pending. A taxpayer must, in the context of a case of this nature, demonstrate more than the fact that he disputes his liability for the tax as assessed and that he is actively pursuing his remedies. It is both unnecessary and undesirable to endeavour to list the circumstances which would justify the exercise of the discretion under s 459J(1)(b) except to say that in the case in which the Commissioner is not shown to have acted oppressively or to have treated the applicant in a manner different from other taxpayers in a similar position, it is not appropriate that the discretion to set aside the demand should be exercised. Section 459J(1)(b) does not provide an occasion for the Court to express its views on the reasonableness or otherwise of the taxation legislation.

In relation to conduct of the Commissioner which HC Legal argued justified the Court exercising its discretion under section 459J(1)(b) to set aside the statutory demand for 'some other reason', HC Legal pointed to:

- the Commissioner's freezing of HC Legal's bank accounts, which lasted for 1 day;[1022]

- an alleged breach of undertaking to defer recovery proceedings. In that regard, His Honour found that the agreement was only for the Commissioner to defer

[1020] [2013] FCA 45, 48.
[1021] Ibid 49.
[1022] Ibid 56-57.

them until after an extension for HC Legal to lodge its objection had expired, which the Commissioner did;[1023]

- a refusal to agree to defer recovery until after the determination of HC Legal's objection and any appeals. The Commissioner refused to do so unless HC Legal was prepared to provide acceptable security for the debt, which HC Legal declined to provide;[1024]

- the garnishee notice the Commissioner issued and directed to HC Legal's bank, which resulted in the recovery of a small amount and which was rescinded after a short time. It is noteworthy that the garnishee notice did not differentiate between HC Legal's operating accounts and its trust account;[1025] and

- HC Legal's suspicion that the assessments were tainted by bad faith. It had made several Freedom of Information requests for the Commissioner's documents relating to the freezing of accounts and the audit, and had received documents in response. His Honour found the documents were not tainted by any bad faith on the part of the Commissioner.[1026]

His Honour held that in all the circumstances of the case he did not consider the Commissioner's actions, individually or collectively, were unconscionable, oppressive, abusive, or productive of substantial injustice.[1027] There was nothing to

[1023] Ibid 58-59.
[1024] Ibid 60.
[1025] Ibid 61-64.
[1026] Ibid 65-66.
[1027] Ibid 67.

justify the exercise of his discretion.[1028] This judgment has not subsequently been appealed.

These cases are clear authority that in applications to set aside a statutory demand, the Commissioner is in a privileged position compared with anyone else. In that regard, the notices of assessment and declarations the Commissioner issues are treated as conclusive evidence that they are correct as to the amount and particulars of the tax liabilities. Further, the legislative provisions give the Commissioner power to continue with recovery actions even if a review on objection or an appeal is pending, as if no such review or appeal was on foot. Accordingly, even though a company may have challenged a tax assessment and an objection or appeal proceeding is pending, this is no bar to the Commissioner issuing a statutory demand, and does not of itself provide grounds to have one set aside under section 459G of the Corporations Act. As a result of these judgments and in particular the HCA's judgment in *Broadbeach*, which has subsequently been applied in numerous cases, the statutory demand regime is potentially one of the Commissioner's most effective debt collection tools.

The Intersection between the Corporations Act and the TAA 1953

As well as considering the operation of the legislative interface within the statutory demand regime, *DCT v Broadbeach Properties Pty Ltd* and *HC Legal Pty Ltd v DCT* required the courts to consider the interaction between two statutory regimes

[1028] Ibid.

established by federal law. The first is the winding up of companies in insolvency which is found in Pt 5.4 (sections 459A-459T) of the Corporations Act and includes provisions for the service of statutory demands on companies for payment of debts. The second regime is established by the provisions for the assessment and collection of income tax and the GST.[1029]

In *Broadbeach*, the HCA made the following observations about the inter-relationship between those competing provisions in the Corporations Act and tax legislation:[1030]

> The present Corporations Act regime for statutory demands was introduced after the enactment of s 177 and contains nothing to suggest that any limitations as to the forum in which an alleged liability can be challenged are relevant. The scope of s 459G of the Corporations Act should not be read down by reference to the provisions of State or Federal revenue laws…
>
> …It is true that s 459G provides for curial decisions to set aside statutory demands and that grants of jurisdiction to superior courts such as the Federal Court and the Supreme Courts are not to be construed with limitations without sufficient reason to do so... But the provisions of the taxation legislation, with an eye to which the statutory demand provisions clearly were drawn, and in particular, the antecedents in what was s 201 of the Assessment Act and now s 14ZZM (as to pending AAT reviews) and s 14ZZR (as to pending Federal Court "appeals"), supply sufficient reason for construing the statutory demand provisions as the Commissioner contends.

The reference in that passage to 'the provisions of the taxation legislation, with an eye to which the statutory demand provisions clearly were drawn' is referring to section 459E(5) of the Corporations Act, which refers to demands relating to income tax liability. Given the approach the HCA took in *Broadbeach* when reconciling the two statutory regimes, it is likely that any inter-relationship between the federal tax regime and any other federal statutory regime is likely to

[1029] The relevant provisions appear primarily in ITAA 1936, ITAA 1997*, A New Tax System (Goods and Services Tax) Act 1999* (Cth), the TAA 1953 and the *Taxation (Interest on Overpayments and Early Payments) Act 1983* (Cth).
[1030] *DCT v Broadbeach Properties Pty Ltd* (2008) 237 CLR 473, 49.

be resolved in a similar manner. In that regard, given the long standing history of the tax regime, the position is likely to be that any Act enacted after the provisions of the tax regime will be presumed to be drafted so as to operate in conjunction with the relevant tax provisions and not side-step or displace them.[1031]

Ameliorating the harsh manner of operation of sections 14ZZM and 14ZZR of the TAA 1953

In the event that the Commissioner institutes a recovery proceeding in respect of an assessment debt while a challenge to that assessment is pending before the AAT or the Federal Court, there are limited options available to the tax debtor to avoid the harsh manner of the operation of sections 14ZZM and 14ZZR of the TAA 1953. Options available include entering into administrative arrangements for the deferral of the disputed debt with the Commissioner or seeking judicial intervention by the granting of a stay of the enforcement of any judgment in respect of the assessment debt by the court in which that recovery proceeding is instituted.

Administrative Arrangements

The Commissioner has the power to defer the time for payment of a tax-related liability having regard to the circumstances of a particular case.[1032] However, the mere existence of that power does not confer upon a tax debtor any right or

[1031] See Full Federal Court in *FCT v Dexcam Australia Pty Ltd (in liquidation)* [2003] FCAFC 148 in relation to the conflict between section 553C of the Corporations Act and subsection 8AAZL(2) of the TAA 1953.
[1032] TAA 1953 s 255-10; ATO, PS LA 2011/14, *General debt collection powers and principles,* para 29-42.

entitlement to its exercise.[1033] The Commissioner will only agree to a deferral of recovery action where the tax debtor has entered into a 50/50 arrangement or where the Commissioner considers that a genuine dispute exists in regard to the assessability of the disputed amount or where the Commissioner is challenging a previously accepted position.[1034]

A 50/50 arrangement involves a tax debtor agreeing to pay all undisputed debts and a minimum of 50% of the disputed debt, cooperating fully in providing any requested information for the early determination of the objection and paying the whole of any subsequently arising tax liability which is not in dispute and for which no other deferral of legal action has been granted.[1035] Following the determination of the objection, if the tax debtor promptly lodges an appeal or requests that the dispute be referred to the AAT, the Commissioner will, depending on a risk assessment, generally extend the period of the 50/50 arrangement until 14 days after the date that the decision is handed down by the relevant appellate tribunal or court.[1036] The Commissioner may take into account the merits of the tax debtor's dispute in deciding whether or not to grant a deferral of legal action.[1037] For example, the merits of the tax debtor's dispute may be taken into account in cases where the Commissioner is taking a position against the weight of precedent cases.[1038]

[1033] ATO, PS LA 2011/14, *General debt collection powers and principles,* para 29.
[1034] Ibid, para 41.
[1035] Ibid, para 22.
[1036] Ibid, para 28.
[1037] Ibid, para 8.
[1038] Ibid.

Granting a Stay of Execution of Judgment

The only judicial intervention available when the Commissioner institutes a recovery proceeding in respect of an assessment debt while a challenge to that assessment is pending before the AAT or the Federal Court is by seeking a stay of execution of judgment.[1039] There is clear authority that there exists jurisdiction in the AAT or the Federal Court to grant such a stay, even against the background of a legislative regime for the collection and recovery of tax which includes sections 14ZZM and 14ZZR of the TAA 1953.[1040]

The issue which has been less clear is whether provisions in tax legislation such as sections 14ZZM and 14ZZR of the TAA 1953, together with the conclusive evidence provisions, preclude the courts from taking into account the merits of pending proceedings under Pt IVC of the TAA 1953 in determining whether or not to stay the execution of a judgment debt. In particular, this issue has created a

[1039] It appears unlikely that a taxpayer could take action under estoppel against the Commissioner to prevent him acting to recover tax. See *FCT v Wade* (1951) 84 CLR 105 at 117 and more recently in *AGC (investments) Ltd v FCT* (1991) 21 ATR 1379 at 1396; Also see Rodney Fisher, 'Constraining the Recovery Powers of the Commissioner: Judicial Considerations in Granting a Stay' (2012) 41 *Australian Tax Review* 200-201; John Bevacqua, 'Public Policy Concerns in Taxpayer Claims Against the Commissioner of Taxation: Myths and Realities' (2011) 40 *Australian Tax Review* 16-17.

[1040] *Australian Machinery & Investment Company Ltd v DCT* (1945) 47 WALR 9, 16-17. 'One reason why the legislative statement could not be construed as having any greater operation may be that so to do would impair the institutional integrity of a court exercising jurisdiction under Ch III of the Constitution and so offend against the constitutional principle stated in *Kable v Director of Public Prosecutions* (NSW) (1996) 189 CLR 51, as explained in *Forge v ASIC* (2006) 228 CLR 45 at 63. To construe the legislative statement as removing the power of a court to grant a stay of a judgment given by it may be to remove one of the defining characteristics of that court. Another reason may be that an inability to grant a stay in the face of the legislative statement would, in the circumstances of a particular case, permit indirectly what neither Parliament nor the Commissioner may do directly, that is arbitrarily to exact money from a person without an ability for that person to challenge the exaction by recourse to an exercise of judicial power. In short, the construction of the then s 201 of the 1936 Act adopted in Australian Machinery & Investment Company, repeatedly judicially applied ever since, may well have a "constructional underpinning": *WR Carpenter Holdings Pty Ltd v FCT* (2008) 237 CLR 198, 10.'

considerable amount of uncertainty post-*Broadbeach*. There are a number of cases which have considered this issue which are explained further below.

Pre-Broadbeach – *Snow* and *Cywinski*

The leading authorities which consider this issue pre-Broadbeach include the Federal Court decision in *Snow v DCT*[1041] and the Victorian appellate decision of *Cywinski v DCT* (Cth).[1042] French J in *Snow* regarded the following considerations relevant to whether or not to grant a stay:[1043]

1. The policy of the ITAA [1936 Act] as reflected in its provisions gives priority to recovery of the revenue against the determination of the taxpayer's appeal against his assessment.
2. The power to grant a stay is therefore exercised sparingly and the onus is on the taxpayer to justify it.
3. The merits of the taxpayer's appeal constitute a factor to be taken into account in the exercise of the discretion (although some judges have expressed different views on this point).
4. Irrespective of the legal merits of the appeal a stay will not usually be granted where the taxpayer is party to a contrivance to avoid his liability to payment of the tax.
5. A stay may be granted in a case of abuse of office by the Commissioner or extreme personal hardship to the taxpayer called on to pay.
6. The mere imposition of the obligation to pay does not constitute hardship.
7. The existence of a request for reference of an objection for review or appeal is a factor relevant to the exercise of the discretion.

From these general propositions in *Snow*, it is apparent that for a court to grant a stay of recovery proceedings, the grounds that a taxpayer needs to establish are broadly either abuse of office by the Commissioner, or extreme personal

[1041] (1987) 14 FCR 119.
[1042] [1990] VR 193.
[1043] *Snow v DCT* (1987) 14 FCR 119, 139.

hardship.[1044] French J concluded in *Snow* that *'*at least some if not the preponderance of authority*'* supported the proposition that the merits may be taken into account in stay proceedings,[1045] however His Honour then immediately also acknowledged that the weight of the merits in the exercise of discretion *'*is attenuated by the fact that it is [the Commissioner*'*s] assessment whose strength is in question*'*.[1046]

In *Cywinski*, Kaye J stated that in some cases, on the basis of relevant material enabling some evaluation of the chance of success, it may be possible to conclude that a taxpayer's objection or appeal is *'*frivolous and hopeless, and therefore totally without merit*'*,[1047] in which case the degree of merit of the appeal would be a determining factor.[1048] Alternatively, Kaye J acknowledged that it might be possible in a particular case to conclude that the disputed assessment was contrary to a HCA decision or unanimous decision of a board of review on facts which were indistinguishable from the particular case, in which case *'*the assessment would be manifestly wrong*'*. In such a case, the taxpayer's objection or appeal would be bound to succeed. Kaye J described an assessment having been made *'*manifestly contrary to law*'* as constituting *'*the condition of a special circumstance*'* which would warrant the exercise of discretion to grant a stay.[1049] Kaye J then addressed

[1044] In cases where the taxpayer is relying on hardship the test has been held to be one of satisfying the court of 'extreme personal hardship'. For example see *DCT v Mackey* [1982] ATC 4571, 4575; Also see Rodney Fisher, 'Constraining the Recovery Powers of the Commissioner: Judicial Considerations in Granting a Stay' (2012) 41 *Australian Tax Review* 195-200; Fisher argues that the courts are taking a broader view of what constitutes extreme personal hardship.
[1045] *Snow v DCT* (1987) 14 FCR 119, 141.
[1046] Ibid.
[1047] *Cywinski v DCT* [1990] VR 193, 196.
[1048] Ibid, 198.
[1049] Ibid.

the more probable intermediate situation of an appeal or objection 'being neither totally without merit nor incontestable because of demonstrated error of law in the making of the assessment'.[1050] His Honour commented that while such cases may be arguable on the merits, of themselves they are insufficient to give rise to special circumstances so as to justify a stay.[1051] Kaye J was of the view that if the court is unable to reach a view as to whether a taxpayer's case was strong or otherwise this resulted in the issue of merits having no significance in the exercise of the discretion.[1052] His Honour added that, in circumstances where it was evident on the basis of the available material that both parties had 'a substantially arguable case to present on the hearing of the appeal', an assessment of the appellant's prospects of success 'would have necessitated his Honour resorting to speculation, an entirely unacceptable course'.[1053]

Post-*Broadbeach* - *Southgate Investment Funds*

DCT v Hua Wang Bank Berhad (No 3)[1054] is a post-*Broadbeach* decision where at first instance Perram J considered that the HCA's decision in *Broadbeach* required him to ignore altogether the pending Federal Court appeal proceedings, with the necessary consequence that the merits of those proceedings were entirely irrelevant to the question whether there should be a stay of execution of the

[1050] Ibid 201.
[1051] Ibid.
[1052] Ibid.
[1053] Ibid.
[1054] [2012] FCA 594.

judgment debts.[1055] He held that *Broadbeach* impliedly overruled decisions such as *Snow* and *Cywinski*.[1056]

The taxpayer case was heard on appeal to the Full Court of the Federal Court in *Southgate Investment Funds Limited v DCT.*[1057] One of the central issues in the appeal was the extent to which, if at all, a court considering an application to stay execution of a judgment arising from a tax assessment is entitled to take into account the merits of any appeal or review proceedings under Pt IVC of the TAA 1953 which are on foot. A related question was whether those issues are effectively determined by the HCA's decision in *Broadbeach*. The Full Court of the Federal Court upheld the taxpayer's appeal from the decision of Perram J. The Court held that Perram J took too broad a view of *Broadbeach* and overstated its relevance. In that regard, the Court relied on the HCA's acceptance of the Commissioner's concession which necessarily means that the HCA did not intend in *Broadbeach* to formulate an absolute rule which requires the merits of Pt IVC proceedings to be disregarded in any case where a court is asked to exercise a discretionary power which could have some impact upon the Commissioner's recovery of a tax debt.[1058]

The Court distinguished *Broadbeach* on the basis that *Broadbeach* arose in a different statutory and factual context and that *Broadbeach* should be viewed in its immediate context, which pertains to the setting aside the statutory demand under the Corporations Act.[1059] Secondly, in *Broadbeach* no issue was raised regarding the

[1055] Ibid 29-30.
[1056] Ibid 31.
[1057] [2013] FCAFC 10.
[1058] Ibid 73.
[1059] Ibid 68.

Court's powers to stay recovery proceedings in circumstances where a Pt IVC of the TAA 1953 review or appeal is on foot.[1060] Accordingly, the Court held that decisions such as *Snow* and *Cywinski* accurately state the relevant principles to be applied and in considering whether to stay a tax debt judgment, the Court could take into account the merits of a pending Pt IVC of the TAA 1953 proceeding.[1061] However, similar in manner to *Snow* and *Cywinski*, the Court stated that even if those merits are assessed, they will need to be balanced with other relevant considerations bearing upon the discretion to grant a stay, including 'the great weight' which has to be given to the legislative policy which accords priority to the recovery of tax debts notwithstanding the existence of Pt IVC of the TAA 1953 proceedings.[1062]

Accordingly, even though a taxpayer has taken the legal avenues open to it to dispute the tax liabilities through the AAT or the Federal Court, due to the 'great weight' which has to be given to the legislative policy which accords priority to the recovery of tax debts notwithstanding the existence of Pt IVC proceedings, in the majority of cases, the merits of the Pt IVC of the TAA 1953 proceedings will not be taken into account in determining whether to grant a stay.

Accordingly, the comments made in Chapter 6 in relation to the unsatisfactory outcomes that have resulted when Pt IVC of the TAA 1953, the conclusive evidence provisions and sections 14ZZM and 14ZZR of the TAA 1953 interrelate with section 260-5 of the TAA 1953 in the context of the Commissioner exercising his discretion to issue a section 260-5 of the TAA 1953 notice are equally applicable in the context

[1060] Ibid 69.
[1061] Ibid 36, 67, 71, 73, 76.
[1062] Ibid 80.

of the court's staying the execution of a judgment debt to issue a taxpayer with a statutory demand notice. In that regard, the great weight that is given by courts to the legislative policy which accords priority to the recovery of tax debts notwithstanding the existence of Pt IVC of the TAA 1953 proceedings will be inequitable to the vast majority of taxpayers who bring appeals on legitimate grounds.

Corporate Insolvency Tax Framework

The discussion of the case law concerning the issuing of a statutory demand notice highlights that the Commissioner is able to substantially improve his position in advance of a corporate failure to the detriment of unsecured creditors in what might be termed a *de facto* priority. In this regard, the discussion of the Framework in Chapter 4 with respect to whether the Framework is better achieved with or without a tax priority is equally as relevant to this discussion. It was concluded in Chapter 4 that the answer to this question cannot be conclusively determined and that the extent of the revenue loss will materially impact upon the criteria of fiscal adequacy, efficiency and equity and is therefore central to the discussion of whether affording the Commissioner tax priority meets the criteria within the Framework. Two possibilities were analysed in Chapter 4, firstly, that the loss to the revenue from abolishing tax priority is minimal or revenue neutral and secondly, that the loss to the revenue from abolishing tax priority is significant. It was concluded that if the corporate rescue and simplicity gains from the removal of priority can be achieved with minimal cost to the revenue, there is a strong argument that the Framework supports the abolition of tax priority. Further, it was

concluded that even if the loss to the revenue from abolishing tax priority is significant, provided that revenue neutrality is achieved in a manner that is more efficient and equitable than tax priority, the Framework will also favour the abolition of tax priority.

Consistently with the conclusion in Chapter 4, that the Framework favours a corporate insolvency tax where the Commissioner does not have tax priority provided that the loss to the revenue is not unduly significant, or even if it is significant, that revenue neutrality is achieved in a manner that is more efficient and equitable than tax priority, so too should the Commissioner's *de facto* priority in side-stepping the possible force of pending tax assessment challenge proceedings be removed. At present, the fiscal adequacy criterion is afforded full force whilst the four remaining, and arguably equally significant, Framework criteria are overshadowed. In addition to analysis in Chapter 4 with respect to the Framework criteria, there are additional arguments that can be made with respect to the corporate rescue and equity criteria which further support law and administrative reform with respect to the way in which the statutory demand regime operates in a corporate insolvency. These additional arguments are discussed below.

Corporate Rescue

There have been a number of concerns about the statutory demand procedure and how it operates in insolvency.[1063] On 14 November 2002, the Parliamentary Joint

[1063] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake* (2004) 221-222; Colin Anderson and Catherine Brown, 'Demanding a change:

Committee on Corporations and Financial Services agreed to consider and report on the operation of Australia's insolvency and voluntary administration laws. The Committee's report was released in June 2004.[1064] Part of the report brought together and reviewed particular criticisms of features of insolvency procedures.[1065] One such criticism concerned the law relating to statutory demands. In particular, the report discussed the submission of Professor Andrew Keay who raised a range of concerns about the statutory demand procedure, including that the law is technical and gives rise to substantial litigation; it does not discourage or prevent insolvent companies from continuing to trade; it is inflexible and harsh in its consequences; and it may be used unfairly against solvent companies.[1066] He commented that 'the procedure and scheme that has been set up has caused certain problems in that a huge number of cases have been heard since 1993. There has been a stream of cases since this year. I would imagine that this is the area that has attracted the most litigation since 1992 and it has produced a rather tangled mass of case law.'[1067]

The Committee made a recommendation that given the law relating to statutory demands is such a central aspect of insolvency law and generates many complaints and litigation it would be appropriate to review the operation of the law of statutory demands. However, the Committee did not make specific

Time to act on statutory demands' (2013) 21 *Insolvency Law Journal* 97; Jasmine Lipton, 'Extending the time for compliance with a statutory demand - A need for commercial certainty' (2008) 16 *Insolvency Law Journal* 211.

[1064] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake* (2004).

[1065] Ibid, Chapter 12.

[1066] Ibid 12, 56.

[1067] Ibid.

recommendations about amendment of the provisions governing the statutory demand procedure.[1068] At this stage, it would seem that no such review has taken place.

The recent case law concerning to the Commissioner's powers in relation to the statutory demand regime may be the catalyst that brings this review back on the agenda. In particular, as a result of the recent case law, when the Commissioner is acting as a creditor in a corporate insolvency, the consequences of the 'inflexible' and 'harsh' statutory demand regime are likely to be even more adverse for the insolvent company than were contemplated at the time of publication of the report. Further, bolstering the Commissioner's priority in this manner is likely to create a situation where stakeholders will take less interest in any proposed reorganisation that will adversely impact on attempts to implement successful corporate rescue.[1069]

All of this is against a background where the major thrust of insolvency reform across many jurisdictions over the last 20 years has been the development of legislation both to facilitate and promote business reorganisations, coupled with a trend towards the removal of tax priorities. Accordingly, the Commissioner's current collection policies suggest the need for reform efforts to ensure that the goals of preserving the integrity of the tax system while also encouraging

[1068] Ibid 12, 59.

[1069] David R M Jackson, 'Forced Collectivization CCRA Style? Creditors Respond to the Latest Source Priority' (2002) 17(1) *National Creditor Debtor Review* 9; Stephanie Ben-Ishai, 'Technically the King Can Do Wrong in Reorganizing Insolvent Corporations: Evidence from Canada' (2004) 13 (2) *International Insolvency Review* 115.

reorganisation are met. There are several options that should be considered in reforming the regime for issuing statutory demand notices by the Commissioner:

- amending the Corporations Act so that the conclusive evidence provisions can be circumvented under section 459G;
- amending the Corporations Act so that a court may properly have regard to whether the taxpayer has a 'reasonably arguable case' in pending proceedings when determining whether to set aside a statutory demand under section 459H(1)(a); and
- publishing a clear and publicly available policy document as to when the Commissioner will issue notices and how he will use the attached rights in the context of a corporate insolvency.

These reforms are likely to impact positively on rescue attempts of insolvent companies.

Equity

The examination and analysis in this chapter of Australia's current legislative interface between the creation of a liability to tax and the right to challenge that liability highlights that the current tax law is serving a revenue purpose. In doing so, it fails to address the need to balance protection of the revenue with protection of taxpayers from the impact of errors in tax administration. This has a particular impact on being able to achieve the equity criterion within the Framework. There are a number of arguments in favour of tax law reform in this area which are discussed below.

Alternate Enforcement Measures Available

One argument in favour of law reform in this area is that there are a number of other options that the Commissioner can utilise to enforce payment of a tax debt that is due and owing under a valid assessment under Part 4-15 of Schedule 1 to the TAA 1953.[1070] As well as the power to issue a taxpayer with a statutory demand notice, a number of other additional enforcement measures are available to the Commissioner which protect the revenue. In that regard, the Commissioner has the power to issue a garnishee notice,[1071] has rights of recovery against liquidators and receivers,[1072] may make an estimate of unpaid amounts of a PAYG withholding or SGC liability and recover the amount of the estimate,[1073] can issue a notice to provide information,[1074] subject the taxpayer to criminal and civil penalties,[1075]

[1070] ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 26.
[1071] TAA 1953 s 260-5.
[1072] TAA 1953 ss 260- 45, 260-75.
[1073] ITAA 1936 Pt VI, Div 8. It is referred to in the ITAA 1936 as the 'System of Prompt Recovery'. Its purpose is stated in the legislation as being 'to enable the Commissioner to take prompt and effective action to recover amounts not remitted as required' by the relevant remittance provisions: ITAA 1936 s 222AFA(1); ATO, PS LA 2011/18, *Enforcement measures used for the collection and recovery of tax related liabilities and other amounts,* para 31 'the making of an estimate is not a measure of last resort, it is a measure which is used routinely whenever it is perceived that it may enhance the speed or efficiency of collection activity'; Further, as part of the normal enforcement processes, the Commissioner will be entitled to serve a statutory demand on the relevant company based on an estimate of the outstanding tax debt. Failure to comply with the statutory demand creates a presumption of insolvency, which is a ground for winding up the company. The relevant winding up provisions are contained in the Corporations Act Part 5.4.
[1074] TAA 1953 s 353-10. The Commissioner's powers under this section are wider and administratively more efficient than the oral examination or enforcement hearing processes. Accordingly, the Commissioner may use these powers in preference to invoking court processes.
[1075] The final legislative sanction for tax debtors who do not pay or enter into an arrangement to pay by instalments, is the liquidation of a company.

issue the taxpayer a departure prohibition order[1076] and take action to recover against directors of companies personally.[1077]

Further, there has been considerable development since the introduction of sections 14ZZM and 14ZZR of the TAA 1953 of enforcement measures that are available to all judgment creditors under the general law, including the Commissioner. These measures include the right to issue writs or warrants of execution, or warrants of seizure and sale, the use of freezing orders preventing debtors dealing with their assets, the use of equitable remedies or declaratory and restitution orders, and accepting security.[1078] Accordingly, the Commissioner can rely upon these powers to protect the revenue.

Appeals Process

Another argument which supports the need for reform is that the taxpayer must also contend with the complicated nature of the tax system and the complicated nature of tax litigation, often resulting in disputes taking a number of years to be resolved through the objection and appeals process.[1079] This can result in a taxpayer experiencing significant delay in recovering the tax that they have paid.[1080] This can have serious cash flow implications for taxpayers which can lead to

[1076] TAA 1953 Part IVA gives the Commissioner the power to issue a departure prohibition order which prohibits the tax debtor from leaving Australia, regardless of whether the tax debtor intends to return.
[1077] TAA 1953 Division 269 imposes a duty upon the directors of a company to ensure that the company either meets its obligations to pay any PAYG withholding and SGC liabilities or goes promptly into voluntary administration or liquidation. The directors' duties are enforced by penalties.
[1078] ATO, PS LA 2011/14, *General debt collection powers and principles*.
[1079] IGT, *Review of Tax Office management of Part IVC litigation*, A Report to the Minister for Revenue and Assistant Treasurer (2006).
[1080] Wayne Gumley and Kim Wyatt, 'Are the Commissioner's Debt Recovery Powers Excessive?' (1996) 25 *Australian Tax Review* 195-201.

premature liquidation of viable businesses.[1081] Further, in the case of corporate rescue attempts post-insolvency, the current regime does not offer the breathing space or respite from the collection activities required to implement a successful corporate rescue.[1082]

Compounding to these cash flow pressures of the company that result from the delay in the appeals process are the additional interest charges that may apply. In that regard, if the taxpayer has had to borrow money to pay the tax liability, the interest on the borrowed money is likely to be at a higher rate than that which is paid by the Commissioner.[1083] Further, the interest rate does not take into account lost 'opportunity cost' of the money used to pay the tax which could have been put back into the business or another investment generating considerable more return. The Commissioner, on the other hand, is not obliged to repay any tax paid until all of his appeal rights have been exhausted.[1084] This could result in the taxpayer being successful in the AAT, Federal Court and Full Federal Court, which may span a number of years, during which no tax is repaid.

Comparative Analysis

Thirdly, support for reform also comes from the fact that Australia's current system for the collection of tax pending review is different to a number of other common

[1081] Tony Knight and Kevin Pose, 'Administration and Appeals' (1997) 26 *Australian Tax Review* 155-161; Wayne Gumley and Kim Wyatt, 'Are the Commissioner's Debt Recovery Powers Excessive?' (1996) 25 *Australian Tax Review* 195-201.
[1082] Ibid.
[1083] ATO, PS LA 2011/23.
[1084] TAA 1953 ss 14ZZL and 14ZZQ.

law countries. The Australian position can be contrasted with that of the US, Canada, the UK and New Zealand.

United States

In the US, if a petition has been filed with the Tax Court, then no assessment of a deficiency and no levy or proceeding in court for its collection shall be made until the decision of the Tax Court has become final.[1085] Further, a refund may be ordered by a proper court, including the Tax Court, of any amount collected within the period during which the Secretary is prohibited from collecting by levy or through a proceeding in court.[1086]

There are several exceptions to this general position. For example, one important exception is that if the IRS finds that the taxpayer intends to depart the US or to remove his/her property or to do any other act which would render ineffectual proceedings to collect income tax.[1087]

Canada

In Canada, a taxpayer who disputes an assessment may file a notice of objection or may, in certain circumstances, appeal directly to the Tax Court of Canada from the assessment.[1088] Where the taxpayer has made payments on account of the disputed amount, or has provided security for that amount, the taxpayer is in most

[1085] *US Code* (US) Title 26 Section 6213. Gregory Germain, 'Discharging their duty: A critical assessment of the Tax Court's refusal to consider bankruptcy discharge questions' (2004) 23(3) *Virginia Tax Review* 531, 540.
[1086] *US Code* (US) Title 26 Section 6213.
[1087] Ibid; Title 26 section 6851.
1088 *Income Tax Act* (Canada) s 164 (1.1). Robin J. MacKnight, 'Recent developments in federal taxation of interest to the resources industries' (1985) 24 *Alberta Law Review* 115, 139-140.

cases entitled to a repayment (or a return of the security).[1089] The taxpayer can keep disputed amounts until the issue is settled, although the taxpayer will be liable for interest if the assessment is upheld.[1090]

There are two exceptions to this general position. Firstly, where a taxpayer is a 'large corporation', the taxpayer is entitled to a repayment or a return of security in respect of only half of any disputed amount.[1091] Secondly, where the amount in dispute is in respect of an assessment of tax, interest or penalties that result from the disallowance of a deduction or tax credit claimed in respect of a tax shelter (as reported by the taxpayer or as determined by the Minister of National Revenue) involving a charitable donation, the taxpayer is entitled to a repayment or a return of security in respect of only half of any disputed amount.[1092]

United Kingdom

In the UK, a taxpayer who appeals against a decision may ask for payment of the amount of tax that they believe to be overcharged to be postponed until the appeal is settled.[1093] The applicant must apply to HMRC for postponement in writing, within 30 days of the decision or assessment stating the amount in which the appellant believes that he/ she is overcharged and the grounds for that belief.[1094] The application for postponement is heard by the Commissioners who determine

[1089] *Income Tax Act* (Canada) s 164 (1.1).
[1090] Ibid.
[1091] Ibid s164(1.1)(d)(ii) within the meaning assigned by s 225.1(8).
[1092] Ibid s 164(1.1)(d)(ii) is amended to provide that this amendment will apply to amounts assessed in respect of taxation years that end after 2012.
[1093] *Taxes Management Act 1970* (UK) s 55(3); Deloitte, *Business Tax Briefing*, 19 February 2010, 2.
[1094] *Taxes Management Act 1970* (UK) s 55(3).

the amount to be postponed.[1095] This amount may also be settled by agreement between the appellant and an inspector.[1096] Interest is payable by the taxpayer if the deferred amount turns out to be due and by HMRC if tax has to be repaid.[1097] If the taxpayer does not make an application for postponement the tax is payable in full whether or not they appeal. On any further appeal, there is no provision for postponement of payment of tax, so that tax is paid (or not paid) in accordance with the decision appealed against.[1098]

Historically, as a matter of practice, HMRC has in general agreed to postpone payments.[1099] However, there have been some recent developments in this area and the HMRC is concerned that by allowing the postponement of payment of disputed tax, it is enabling taxpayers to prolong disputes unnecessarily.[1100] The HMRC has recently issued a consultation paper in which it proposes to require individuals and companies to pay the tax in dispute during an enquiry or appeal relating to tax avoidance.[1101] Accordingly, in the UK there is likely to be some developments in this area shortly.

New Zealand

In New Zealand, the amount of tax which must be paid pending an appeal is determined by whether the taxpayer has made a 'competent objection' or a 'non-

[1095] Ibid s 55(5).
[1096] Ibid s 55(7).
[1097] Ibid s 86.
[1098] Ibid s 55(3).
[1099] Ison, Kate and Aude Delechat, 'HMRC Enquiries: To Pay or Not to Pay', *Accounting Web*, 10 March 2014.
[1100] UK, HMRC, *Tackling Marketed Tax Avoidance Consultation Document* (2014).
[1101] Ibid.

qualifying objection'.[1102] If the taxpayer has made a competent objection, the tax in dispute is split into deferrable and non-deferrable components. The non-deferrable tax has to be paid to the Commissioner while the deferrable amount is not to be paid pending resolution of the dispute.[1103] This is despite the fact that both amounts are owing pursuant to a valid assessment. The deferrable tax will be equal to the amount of tax assessed under a tax law or GST payable by a taxpayer or disputant on a due date in relation to which the taxpayer makes a competent objection, or that the disputant challenges as payable.[1104] The deferrable tax includes that which relates to any tax in dispute or a shortfall penalty, where the penalty is payable in respect of any tax in dispute or the interest accruing on that deferrable tax or that shortfall penalty until the due date for payment of that deferrable tax. The deferrable tax is due and payable on the day which is the thirtieth day after the day of determination of final liability.[1105] Accordingly, if the taxpayer contests the correctness of an assessment, they will be relieved as a result of not having to pay the deferrable amount. There is an exception if the Commissioner considers there to be a significant risk that the tax in dispute will not be paid should the taxpayer not succeed in the appeals process. In this instance, the Commissioner can require a taxpayer to pay all tax in dispute.[1106]

[1102] Mallesons Stephens Jaques, *Submission to the Review of Business Taxation: Reform of Payment of Tax Pending Review or Appeal* (1998), 5.2.
[1103] *Tax Administration Act* (New Zealand) s 128(2).
[1104] Ibid.
[1105] Ibid.
[1106] Ibid ss s 128(2), 128(2B).

The issue of whether disputed tax debt should be recoverable prior to the outcome of the appeals process being determined was considered by Blanchard J in *Miller v C of IR*.[1107] His Honour commented as follows:[1108]

> Nevertheless, it does not follow that the Commissioner would be justified in enforcing his post-assessment right to non-deferrable tax under s 34 [section 128 and section 1381 of the TAA 1953] pending the conclusion of the objection procedures, except in such a way as may be necessary or prudent to protect the position of the revenue.
>
> ...The Commissioner is by s 34 given very large and unusual powers and, where the fate of an objection is not clear cut, the Commissioner should use those powers sparingly. Seizure and certainly sale of assets may often be unjustified. The Commissioner ought also to proceed cautiously in the bringing of bankruptcy proceedings, particularly if security can be obtained or there is some other means of ensuring that available assets can be preserved until objections are determined. It would be cruel and inappropriate if a citizen should without good cause be made bankrupt by an agency of the State when ultimate liability for the debt in question has not been determined and, indeed, may be found not to exist. The Courts will lean in favour of protecting a taxpayer where the Commissioner's powers are being used excessively.

The New Zealand courts appear to be open to taking this approach provided that the taxpayer is not engaging in tax evasion or is at risk of the assets of the taxpayer being dissipated.[1109]

Options for Reform

Any reform measures that are introduced must balance the need to protect the taxpayer against erroneous assessments from the ATO whilst ensuring that integrity measures are put in place that prevent tax payers engaging in tax evasion. The discussion in relation to the jurisdictions above provide examples of how this could be achieved. Further, there are a number of options for legislative reform. In

[1107] (1993) 15 NZTC 10, 187.
[1108] Ibid 10, 206 RHC.
[1109] See *Anzamco Ltd (in liq) v Bank of New Zealand* (1982) 5 NZTC 61249; *Miller v C of IR* (1993) 15 NZTC 10,187; this strict approach seems to have been evident in *Hieber v C of JR* (2000) 19 NZTC 15716.

addition to the options described above in relation to the tax systems of the jurisdictions outside of Australia, commentators have also suggested alternative options. One commentator argues that another option for reform is the introduction of a threshold test for determining genuine disputes which would be the 'reasonably arguable position test' which is used in various tax provisions and is legislatively defined in section 284-15(1) of Schedule 1 of the TAA 1953.[1110] Other commentators have suggested that tax recovery should be allowed if the taxpayer fails to have the assessment set aside after a first instance hearing on the merits by the AAT of Federal Court.[1111]

Conclusion

This chapter has considered one of the 'firmer action' tools that the Commissioner has at his disposal to enforce the tax law and ensure prompt collection of tax debts. One of the major themes that has emerged in this chapter is how the Commissioner's desire to achieve fiscal adequacy can adversely impact upon the other criteria within the Framework, particularly that of achieving successful corporate rescue post-insolvency.

The Commissioner can justify his current position based on fiscal adequacy and therefore revenue collection being the primary objective of tax law.[1112] As

[1110] Rodney Fisher, 'Constraining the Recovery Powers of the Commissioner: Judicial Considerations in Granting a Stay' (2012) 41 *Australian Tax Review* 198-200.
[1111] Wayne Gumley and Kim Wyatt, 'Are the Commissioner's Debt Recovery Powers Excessive?' (1996) 25 *Australian Tax Review* 201.
[1112] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 10; Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 3; Australian Treasury, Taxation Review Committee*, Full Report* (1975) 11.

discussed in Chapter 2, this objective was most recently expressed as being the 'primary objective' of the tax system in the Henry Review.[1113] Accordingly, it appears that the reason for the conflict between the Commissioner (tax law) and achieving successful corporate rescue (a key objective of insolvency law) is premised upon the underlying and conflicting theoretical perspectives of both these areas of law. In order to create greater harmony at the intersection of tax law and insolvency law, the Commissioner must take on a role in a corporate insolvency that will allow him to positively impact on corporate rescue attempts yet not compromise the fiscal adequacy requirement. This could be achieved through legislative reform or policy change. A number of options for reform have been discussed in this chapter, but given the number of stakeholders involved, it would be prudent to engage in some form consultation prior to any proposed reforms being legislated.

The other major theme that has emerged from this chapter is that the current tax law fails to address the need to balance the public interest in protecting the revenue, against the public interest in protecting taxpayers against the impact of erroneous assessments. As a result, the equity criterion within the Framework cannot be achieved without law reform that is aimed at creating a fairer appeals process in cases of disputed debt.

As a final point, an interesting area for further research that was advanced by the HCA in *Broadbeach* was that there was no argument advanced by the respondents

[1113] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.

in either *Broadbeach* or the earlier Federal Court case of *Futuris Corporation Ltd v FCT*[1114] challenging the constitutional validity of section 177(1) of the ITAA 1936. A number of commentators have considered and tried to reconcile the scope of section 177(1) of the ITAA 1936 and various constitutional provisions.[1115] In that regard, it is likely that a court will be asked to consider this argument in the future, and if section 177(1) of the ITAA 1936 is found to be *ultra vires* and therefore unconstitutional, this will impact considerably on the operation of the statutory demand regime and may also put into question the constitutional validity of a number of other provisions of the tax legislation which appear to impose a liability to tax on a taxpayer in an 'arbitrary or capricious manner'.[1116]

The final chapter of this thesis will summarise the results and recommendations of this thesis, calling for their implementation. Possibilities for future studies will also be discussed.

[1114] [2009] FCA 600.

[1115] Nabil F Orow, 'Challenging an Assessment Otherwise Than Through Prescribed Procedures Under the Income Tax Assessment Act' (1996) 24 *Australian Business Law Review* 195-207; Peter K Searle, 'Defending Tax Recovery and Bankruptcy Proceedings' (1990) 19 *Australian Tax Review* 166-169; Frank Zumbo, 'Challenging an Income Tax Assessment: Is a Taxpayer Confined to the Provisions of Part IVC of the Taxation Administration Act 1953?' (1993) 22 *Australian Tax Review* 120-131.

[1116] Ibid; *WR Carpenter Holdings Pty Ltd v FCT* [2008] HCA 33 the HCA applied three propositions set out in *Giris Pty Ltd v FCT* (1969) 119 CLR 365., *MacCormick v FCT* (1984) 158 CLR 622 at 639-641 and *DCT v Truhold Benefit Pty Ltd* (1985) 158 CLR 678 at 687-688 to determine the validity tax laws under challenge: 'First, for an impost to satisfy the description of taxation in s 51(ii) of the Constitution it must be possible to distinguish it from an arbitrary exaction. Secondly, it must be possible to point to the criteria by which the Parliament imposes liability to pay the tax; but this does not deny that the incidence of a tax may be made dependent upon the formation of an opinion by the Commissioner. Thirdly, the application of the criteria of liability must not involve the imposition of liability in an arbitrary or capricious manner; that is to say, the law must not purport to deny to the taxpayer "all right to resist an assessment by proving in the courts that the criteria of liability were not satisfied in his case".'

Chapter 9 - Conclusion

Introduction

This thesis began by considering Australia's current economic climate, which eight years post the GFC continues to be uncertain. [1117] These economic pressures have been a catalyst for the continual growth of ATO collectable debt and corporate insolvencies over this period.[1118] In this environment, the role of government in providing financial assistance to financially troubled businesses, to smooth consumption and absorb economic shocks has become increasingly important, however at the same time the adequacy of tax revenues is also being questioned.[1119] This ongoing tension between the concern over the adequacy of tax revenues and the increase in the rate of corporate insolvencies provides justification for the development of a more appropriate theoretical framework to assess the effectiveness of laws and administrative practices that sit at the intersection of tax law and corporate insolvency law.[1120]

Applying the Framework for Corporate Insolvency Tax

The literature review in Chapter 1 highlighted that with respect to contributions to research in Australia, there have been some limited studies in the area of the

[1117] FCT, *Annual Report 2013-14*, 14; Emma Armson, 'False trading and market rigging in Australia' (2009) 27 *Company and Securities Law Journal* 411.
[1118] FCT, *Annual Report 2014-15* (2015) 44; Jones Partners, *Insolvency Report 2014: Insolvency Activity and the State of the National Economy — The Past, Present and Future* (2014) ii.
[1119] FCT, *Annual Report 2014-15* (2015) 44; Australian Government, IGT, *Debt Collection, A report to the Assistant Treasurer* (2015); Parliament of the Commonwealth of Australia, House of Representatives Standing Committee on Tax and Revenue, *Tax disputes* (2015); Business Council of Australia, *The Future of Tax: Australia's Current Tax System* (2014) 2.
[1120] Ibid; Jones Partners, *Insolvency Report 2014: Insolvency Activity and the State of the National Economy — The Past, Present and Future* (2014) ii.

intersection of tax law and insolvency law. In particular, no research to date has developed and applied a theoretical framework to the area of corporate insolvency tax law. A theoretical Framework was developed in Chapters 2 and 3 of this thesis.

This thesis developed a theoretical Framework that deals explicitly with corporate insolvency tax by researching the theoretical perspectives of tax law and then using these perspectives to find a counterpart theoretical perspective in insolvency law. The analysis in Chapters 2 and 3 supports the emergence of a theoretical perspective of corporate insolvency tax that embraces a perspective that forms the crossroads of the theoretical perspectives of tax law and the communitarian perspective in insolvency law.

The Framework that is developed around this perspective is comprised of five criteria. That is, at the crossroads of tax law and insolvency law sits a corporate insolvency tax system which is aimed at achieving fiscal adequacy, corporate rescue, equity, efficiency and simplicity. Corporate insolvency tax laws should be aimed at achieving as many of these criteria as possible, and if trade-offs must be made there must be clear and continuous reference to these theoretical perspectives.

The Framework has been used to assess and evaluate the level of harmony between these areas of law in relation to select issues concerning the role of the Commissioner as a creditor in a corporate insolvency. In particular, the theoretical Framework was applied to answer the following key questions:

1. Should the Commissioner have priority in a corporate insolvency?

2. Is there harmony at the intersection of tax law and insolvency law with respect to the Commissioner's debt collection practices in the context of tax administration?

3. Is there harmony at the intersection of tax law and insolvency law with respect to the Commissioner's powers to issue:

    a. notices under section 260-5 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) (TAA 1953)?

    b. director penalty notices under Division 269 to Schedule 1 of the TAA 1953 (DPNs)?

    c. statutory demand notices under section 459E of the *Corporations Act 2001* (Cth) (Corporations Act)?

Results and Recommendations

The Commissioner's Priority

As discussed in Chapter 4, the Framework favours a corporate insolvency tax where the Commissioner does not have tax priority, however such a conclusion is qualified. In that regard, additional research must be conducted to determine the extent of the loss to the revenue as a result of the abolition of tax priority. If the loss to the revenue is not material, then the Framework favours the removal of tax priority in a corporate insolvency and the treatment of the Commissioner as a general unsecured creditor. However, if the loss to the revenue is significant the Government must put in place measures to either collect revenue from the

insolvent company through its administrative and enforcement powers or alternatively, through diversifying its insolvency risk through a tax-shift. For example, it may be the case that a revenue neutral shift from corporate insolvency tax priority to a less distortionary property tax could have the effect of achieving increased vertical equity (as progressive property taxes are effectively a tax on wealth) and favour the reorganisation of viable businesses.[1121] If this tax-shift were to occur, it would have minimal distortionary effects and would be considered efficient.[1122] It is clear that the optimum measure to be taken is that which best achieves the criteria within the Framework.

The Commissioner's Insolvency Debt Collection Practices

As discussed in Chapter 5, in the context of a tax debtor that is approaching insolvency or that is insolvent, it is evident that the manner in which the ATO administers the tax law has the potential to impact upon a number of stakeholders. An analysis of the criteria within the Framework indicates that there is currently a degree of disharmony at the intersection of tax law and insolvency law with respect to the Commissioner's insolvency debt collection practices. This analysis has provided useful insights in relation to where weaknesses in the ATO's insolvency debt collection administrative function lie. In that regard, there are a number of

[1121] Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, *Tax and Economic Growth*, OECD Economics Department Working Papers (2008). The indications from this analysis are that property taxes have the least detrimental impact on growth. The OECD analysis only looks at the issue of the tax mix from the perspective of economic efficiency. Also see European Commission, *Tax reforms in EU Member States Tax policy challenges for economic growth and fiscal sustainability,* Taxation Papers: Working Paper N.34/2012, 2012 Report (2012).
[1122] Ibid.

administrative measures that can be taken to better achieve the criteria within the Framework. These include:

- implementing strategies aimed at early intervention. Many of these techniques are currently being implemented in a number of jurisdictions outside Australia and include dynamic risk clustering, the use of predictive data models, preventative interventions, preventative communication and preventative dialogue.[1123]

- revising the ATO's administrative practices so that when a corporate debtor signals cash flow difficulties, pre-emptive action will include a mandatory assessment of business viability at the early intervention stage within the ATO's Debt Management Framework. Such a mandatory process would enhance the risk assessment that is currently being undertaken, allowing the ATO to determine its response to the tax debtor. For example, if an assessment is made that the business is viable in the long-term, an action plan can be developed to assist the business to meet its outstanding tax obligations.[1124] However, if the business is considered to be unviable in the long-term the ATO can take appropriate action to mitigate its losses by preventing the business continuing its poor compliance record and escalating its debt.

- adopting more flexible debt relief mechanisms in certain cases. For example, the ATO could re-introduce the Small Business Debt Assistance Initiative which is likely to encourage greater engagement with tax debtors, thereby increasing

[1123] Ibid 29.
[1124] IGT, *Review into the Tax Office's Small Business Debt Collection Practices*, Summary of Submissions and Evidence (2005) 68.

compliant taxpayer behaviour and assist to reduce current levels of ATO aged debt.

- capturing more qualitative information about the tax debtor with the use of advancements in technology. Extrapolating information relating to the tax debtor's business-related economic and financial indicators as well as the tax debtor's demographics will provide the ATO with a better understanding of the small business debtor's context. This assessment is critical for the ATO to be able to assess small business debtors who 'want to comply but are unable to do so in the short-term; debtors who are incapable of complying (probably ever); and those debtors who are unwilling to comply'.[1125] The outcome of this assessment will then be used to determine the most appropriate form of ATO intervention, thereby balancing the interests of all stakeholders.

- integrating tax compliance as a natural part of taxpayers' business processes. One possibility for achieving integrated compliance is by making greater use of third party withholding and reporting. The development of new technology and new strategies creates more opportunities for integrated compliance resulting in taxpayers paying taxes in real-time, paying directly as they earn and paying per transaction they make.

- developing online resources to further improve ATO online service delivery. In particular, the online experience should be customised and comprehensive

[1125] Australian National Audit Office, *The ATO's Administration of Debt Collection—Micro-business*, Auditor General Audit Report No.42, Performance Audit (2006–07) 42.

and should be similar to the online experience that is currently being provided by Australia's financial institutions and major retailers.

The Commissioner's Powers to Issue Notices under Section 260-5 of Schedule 1 to the TAA 1953

As discussed in Chapter 6, the issue of a section 260-5 of Schedule 1 to the TAA 1953 notice, if administered correctly, can protect the revenue and also achieve efficiency and equity in the tax system. However, it is questionable whether these same objectives can be achieved in the context of corporate insolvency. In that regard, it can be argued that each of the criteria in the Framework can be adversely impacted if the enforcement measures employed by the Commissioner allow him to gain an advantage over unsecured creditors in corporate insolvency proceedings.

The Commissioner is increasingly relying upon this legislative instrument to create a *de facto* priority in a corporate insolvency, thereby gaining an advantage over general unsecured creditors and sometimes secured creditors. While the Commissioner is protecting the revenue, the current tax law is undermining the external administration process, particularly corporate rescue efforts. When the tax laws concerning section 260-5 of Schedule 1 to the TAA 1953 notices interrelate and conflict with insolvency law, the fiscal adequacy criterion of tax law is displacing the key objectives of insolvency law. This is creating considerable tension at the intersection of both of these areas of law.

The Framework supports the removal of the Commissioner's *de facto* priority that section 260-5 of Schedule 1 to the TAA 1953 notices create. It is argued that this

would create greater efficiencies, be more equitable and simple and give companies that show signs of long term viability the best chance of survival post-insolvency. Accordingly, the manner in which section 260-5 notices interrelate with the insolvency process is unsatisfactory and options for reform must be considered so that the criteria within the Framework can be achieved which will result in greater harmony at the intersection of tax law and insolvency law. Possible options for reform include:

- amending the TAA 1953 to make the section 260-5 notices ineffective as soon as a corporate debtor enters into any form of external administration under the Corporations Act;
- amending the TAA 1953 to make the notices ineffective, if served before the commencement of the tax debtor's winding up but after the 'relation-back day' for the tax debtor; and
- amending the Corporations Act to enable section 260-5 notices to be set aside as unfair preferences if they are issued six months before the 'relation-back day' for a tax debtor.

The Commissioner's Powers to Issue Director Penalty Notices under Division 269 to Schedule 1 of the TAA 1953

As discussed in Chapter 7, the current director penalty regime is achieving the fiscal adequacy, efficiency and equity criteria within the Framework as well as fostering a culture of corporate rescue, indicating that these provisions in the tax law interrelate and align with insolvency law more harmoniously than the other powers

of the Commissioner to recover outstanding tax debts that have been examined in this thesis.

It is considered that the greater alignment of the director penalty regime is driven by the fact that the director penalty regime was introduced as a substitute for the Commissioner's priority and was aimed at encouraging directors to take early positive action to deal with insolvency. Accordingly, the director penalty regime was a product of both tax law and insolvency law coming together to develop an enforcement mechanism equipped to achieve the key objectives of both areas of law. This can be contrasted with the enforcement powers of the Commissioner discussed in Chapters 6 and 8 of this thesis where the tax law has been enacted with no regard to the insolvency process, often leading to significant disharmony at the intersection of these areas of law.

It is argued that while there is scope to extend the director penalty regime further, perhaps the right balance has already been achieved. In that regard, although the provisions operate in a harsh manner, they encourage early intervention by directors to take action to resolve cash flow problems as soon as they arise, encourage directors to actively participate in the management of the company and therefore foster a culture of good corporate governance, and mitigate the insolvency risk to other stakeholders that will be adversely impacted by the demise of the company. There is however considerable opportunity to put mechanisms in place to educate directors as to their obligations and of the consequences of failing to meet them which would make the regime much simpler.

The Commissioner's Powers to Issue Statutory Demand Notices under Section 459E of the Corporations Act

As discussed in Chapter 8, the case law concerning the Commissioner's power to issue statutory demand notices under section 459E of the Corporations Act highlights that in applications to set aside a statutory demand by the tax debtor company, the Commissioner is in a privileged position compared with anyone else. When the power to issue statutory demand notices under section 459E of the Corporations Act interrelates with a number of provisions in the TAA 1953, the fiscal adequacy criterion of tax law displaces the key objectives of insolvency law, particularly that of achieving successful corporate rescue post-insolvency. This is creating considerable tension at the intersection of both of these areas of law.

Further, the current tax law concerning the Commissioner's power to issue statutory demand notices fails to address the need to balance the public interest in protecting the revenue against the public interest in protecting taxpayers against the impact of erroneous assessments. As a result, the equity criterion within the Framework cannot be achieved without law reform aimed at creating a fairer appeals process in cases of disputed debt.

Accordingly, the manner in which section 459E of the Corporations Act notices interrelate with the insolvency process is unsatisfactory and options for reform must be considered so that the criteria within the Framework can be achieved, which will result in greater harmony at the intersection of tax law and insolvency law. Support for reform also comes from the fact that our present system is contrary to the systems for the collection of tax pending review in other common

law countries. There are several options that should be considered in reforming the regime for issuing statutory demand notices by the Commissioner. These include:

- amending the Corporations Act so that the conclusive evidence provisions can be circumvented under section 459G;
- amending the Corporations Act so that a court may properly have regard to whether the corporate tax debtor has a 'reasonably arguable case' in pending proceedings when determining whether to set aside a statutory demand under section 459H(1)(a);
- publishing a clear and publicly available policy document as to when the Commissioner will issue notices and how he will use the attached rights in the context of a corporate insolvency;
- adopting a system for the collection of tax pending review that is more balanced, such as that of Canada, the US, the UK or New Zealand; and
- adopting alternative options which have been suggested by other commentators such as:
    - the introduction of a threshold test for determining genuine disputes which would be the 'reasonably arguable position test' which is used in various tax provisions and is legislatively defined in section 284-15(1) of Schedule 1 of the TAA 1953;[1126] and

[1126] Rodney Fisher, 'Constraining the Recovery Powers of the Commissioner: Judicial Considerations in Granting a Stay' (2012) 41 *Australian Tax Review* 198-200.

- allowing tax recovery if the taxpayer fails to have the assessment set aside after a first instance hearing on the merits by the AAT or Federal Court.[1127]

These reforms are likely to impact positively on rescue attempts of insolvent companies as well as better achieve the other criteria within the Framework.

Future Research

Applying the Framework More Broadly

This thesis is limited in its scope to the application of the Framework to a select number of issues that concern the role of the Commissioner as a creditor in a corporate insolvency. However, the Framework has been developed so that it can be applied to analyse the effectiveness of any laws and administrative practices that sit at the intersection of tax law and insolvency law. Accordingly, future research in the area of the intersection of tax law and insolvency law could utilise the Framework as a tool to assess the effectiveness of any laws and administrative practices that sit at the intersection of these laws. This may include an analysis of the number of additional powers available to the Commissioner under the TAA 1953 as well as other federal tax legislation to recover outstanding tax debts from a tax debtor that have not been analysed in this thesis.

Further, the role of the Commissioner as a creditor in a corporate insolvency is only one area of intersection of tax and insolvency law, and in that regard the

[1127] Wayne Gumley and Kim Wyatt, 'Are the Commissioner's Debt Recovery Powers Excessive?' (1996) 25 *Australian Tax Review* 201.

Framework can be applied in future research to other areas that sit at this intersection. For example, it could be applied to test the effectiveness of laws and administrative practices in relation to the tax status of an entity under insolvency administrations, the tax obligations of external administrators, share capital restructuring, share disposals and distributions on liquidation, transactions involving debts, debt reconstructions, carry forward of deductions for losses and bad debts, asset valuations and depreciation, CGT issues and GST and insolvency.

Further, the Framework can be used as a tool which extends to research involving comparative studies. An examination of the laws and administrative practices in jurisdictions outside of Australia would be particularly useful where law reform initiatives are being proposed from these jurisdictions. In these cases, an assessment can be made as to whether these laws and practices fall within the Framework in determining whether the reform proposal has merit.

Combining the Framework with Economic Analysis

In relation to the research questions in this thesis, future applied research involving empirical data would be helpful in providing the quantitative data that is necessary to make an accurate assessment of the loss to the revenue from the abolition of priority. This empirical research would allow the research questions in this thesis to be answered from a different paradigm.

Further, an in-depth economic analysis of the impact of tax on corporate tax debtors and other key stakeholders in Australia is required in future studies to assess the true extent and impact of the actions of the Commissioner in a corporate

insolvency. This economic analysis would also allow the research questions in this thesis to be answered from a different paradigm.

Conclusion

The major theme to have emerged from this thesis is that when the tax laws and administrative practices concerning the role of the Commissioner in a corporate insolvency interrelate and conflict with insolvency law, the fiscal adequacy criterion of tax law is displacing the key objectives of insolvency law. In particular, that of being able to achieve successful corporate rescue post-insolvency. This is creating considerable tension at the intersection of both of these areas of law.

The Commissioner can justify his current position based on fiscal adequacy and therefore revenue collection being the primary objective of tax law.[1128] As discussed in Chapter 2, this objective was most recently expressed as being the 'primary objective' of the tax system in the Henry Review.[1129] Accordingly, it appears that the reason for the conflict between the Commissioner (tax law) and achieving successful corporate rescue (a key objective of insolvency law) is premised upon the underlying and conflicting theoretical perspectives of both these areas of law. The Framework has been developed as a new theoretical perspective which aligns the theoretical perspectives of both of these areas of law. It has been developed as a tool that can be used to assess the current legislative

[1128] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 10; Australian Treasury, *Taxation Reform: Problems and Aims,* Treasury Taxation Paper No. 1 (1974) 3; Australian Treasury, Taxation Review Committee*, Full Report* (1975) 11.
[1129] Australian Treasury, *Australia's Future Taxation System*, Report to the Treasurer (2009) 17.

and administrative framework and to propose options for reform in order to create greater harmony at the intersection of tax law and insolvency law.

The Commissioner must take on a role in a corporate insolvency that will allow him to positively impact on corporate rescue attempts, yet not compromise the fiscal adequacy requirement or adversely impact upon the integrity of the tax sytem. This could be achieved through legislative reform or policy change.

A number of options for reform have been discussed in this thesis. Any options for reform should be aimed at achieving as many of the criteria within the Framework as possible, and if trade-offs must be made there must be clear and continuous reference to these theoretical perspectives which will offer a means of assessing reform proposals in a manner that is legally coherent, commercially efficient and politically acceptable. Given the number of stakeholders involved, it would be prudent to engage in some form consultation prior to any proposed reforms being legislated.

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