The ATO and loss of priority in insolvency: Does tax expenditure analysis provide a solution?

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History

- The 1978 Senate Standing Committee on Constitutional and Legal Affairs on the Priority of Crown Debts (the Missen Report)
- Bankruptcy Amendment Act 1980
- Taxation Debts (Abolition of Crown Priority) Act 1980
- Crown Debts (Priority) Act 1981
- The 1988 ALRC General Insolvency Inquiry (the Harmer Report)
Pari Passu principle - Harmer

It is the view of the Commission that, to the maximum extent possible, the principle of equality should be maintained by insolvency law subject to these 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.

Australian Law Reform Commission, General Insolvency Inquiry, Report No 45, Canberra, 1988, [713]
Post Harmer

• General consensus
  – Priority had to be abolished for voluntary administration regime to succeed
  – Revenue impact would be insignificant

• Subsequent legislation
  – *Insolvency (Tax Priorities) Legislation Amendment Act 1993*
  – *Taxation Laws Amendment Bill (No 3) 1995*
Some key points

- The DPN regime was introduced to ensure success of reform (VA procedures) and as a trade off for loss of priority.
- The ‘insignificant revenue’ measure dates back to the 1978 Missen Report. Questionable as to whether the amount of tax revenue foregone in insolvency is still insignificant.
- The pari passu doctrine remains the preferred approach from a corporate law point of view but is not tax policy. Nor is it necessarily overarching rule of public policy which can be applied by the Court in resolving conflicts in priority (see High Court in *International Air Transport Association v Ansett Australia Holdings Limited*)
Areas of conflict between ATO and insolvency

- GST
- Section 260-5 notice (Park decision)

More recently...
- Section 254 ITAA 1936 and CGT
- DPN regime
Section 254

• Section 254(1) – every agent and trustee must:
  – (a) do all such things as are required to be done by virtue of the Act, including CGT, and for payment of resulting tax liability.

• Section 254(1)(d)
  – Agent and trustee “authorized and required to retain from time to time out of any money which comes to him or her in his or her representative capacity so much as is sufficient to pay tax which is or will become due in respect of the income, profits or gains.”

Section 254

• TD2012/D6: Whether income tax have been assessed before an agent or trustee has an obligation under section 254 to retain (entire) tax owed while trustee/agent

• Impact of Determination: Section 254(1)(d) will apply regardless of whether tax has been assessed despite case law suggesting this approach is incorrect.
Section 254

• TD2012/D7 – Whether a receiver who disposes of a CGT asset as the agent for a debtor have an obligation under section 254 to retain (entire) tax owed on disposal

• Impact of Determination: a receiver will be required to retain an amount sufficient to pay in full any CGT liability from the proceeds of sale regardless of period of time the asset was held by the tax payer.
DPN regime

- Introduced in 1993 to ensure effectiveness of voluntary administration process
- Objective: per s269-5 (Sch 1 TAA 1953) to ensure that a company either:
  - (a) meets its obligations … or
  - (b) goes promptly into voluntary administration under the Corporations Act 2001 or into liquidation.
- Directors have 21 days after notice to comply (s 269-25)
- ATO not to commence proceedings until end of this period (s 269-25)
- Served by posting to address of the place of residence or business of the person last known to the person serving the document (s 269-50)
- Director can enter into a payment arrangement with ATO but this will not prevent issue of a DPN (s 269-15)
- Issue of DPN does not prevent s 260-5 notice being issued.
- Supplemented by s 588FGA of the Corporations Act – ATO indemnified against directors where an insolvent corporation pays its tax debt, and that debt is later recovered as a voidable preference payment.
- ATO is in effect a guaranteed creditor.
Possible reasons for inconsistencies

- Abolition of the specific Crown priority only went so far to deal with the issues that existed at the time.
- Greater emphasis on anti-avoidance etc leading to increased use by the ATO of its broader collection powers.
- A general lack of recognition by those drafting legislation of the broader context that law operate.
- The underlying principles of insolvency and taxation law have not been revisited since the theoretical abolition of the ATO priority.
Is it time to review the policy?

Any departure from [the pari passu approach] should only be countenanced by reference to clearly defined principles or policies which enjoy general community support.

Can *pari passu* be justified as a policy for priority of the ATO?

- Pari passu is a corporate law concept.
- There is no tax law principle on which issues of competing interests on insolvency can be resolved.
Can tax expenditure analysis assist the debate?

• Concepts worth considering:
  – Defining the tax revenue foregone in insolvency as an implicit tax expenditure
  – Increasing fiscal transparency
  – Evaluating reform by non-traditional tax criteria
Definition

• Consolidated TES 2011
  – “…a provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the ‘standard’ tax treatment that would apply.”
  – “…may also redistribute the tax burden between taxpayers, as most tax expenditures result in less tax being collected from particular taxpayers.”

• Typically tax exemptions, tax deductions, tax offsets, concessional tax rates or deferrals of tax liability.

• However, arguably includes implicit tax expenditures – for eg where judicial interpretation of an deductible expense as a being capital in nature (eg Krever, Sadiq etc)
Measurement in Australia

• The revenue forgone approach
  – “measures the difference in tax paid by taxpayers who receive a particular concession relative to similar taxpayers who do not receive that concession. It compares the current/prospective treatment to the benchmark treatment, assuming taxpayer behaviour is unchanged. Accordingly, revenue forgone tax expenditures measure the impact of a concession in terms of the benefit taxpayers derive from the concession given their behaviour once it is in place.”
Benchmark

- Two principles (per Consolidated TES 2011)
  - Standard taxation treatment as applies to similar taxpayers or types of activity.
  - The structural elements of the tax system where there are difficulties adopting the standard treatment as the benchmark.

- Eg personal income tax benchmark:
  - a tax base including all nominal income less expenses incurred in earning income;
  - a tax scale comprising tax rates, associated income tax thresholds, Medicare levy and low income tax offset;
  - the individual as the tax unit; and
  - the financial year as the tax period.
Tax expenditure analysis

A significant purpose of the tax expenditure analysis is to bring transparency to government programs advanced through the tax system, recognizing that these indirect government programs often pass under the radar screen with far less scrutiny than direct government programs receive.

Evaluation

“Tax expenditures cannot be understood or evaluated using the traditional tax criteria of equity, neutrality and simplicity; instead, they can only be understood and must be evaluated using budgetary criteria – the same criteria used in evaluating direct spending programs.” (Brooks)
Example – DPN reform for phoenix activity

• Primarily aimed at reducing loss of tax revenue through phoenix activity
• Three key amendments:
  – DPN extends to any unpaid superannuation guarantee charge
  – More difficult for directors to remit the penalty
  – PAYG Withholding Non Compliance tax
Approach taken in drafting the legislation

….. some aspects of the director penalty regime limit its efficacy in ensuring that directors cause their companies to comply with their obligations, including in phoenix cases. Most notably, as directors are provided 21 days’ notice of the penalty before the Commissioner is able to commence proceedings to recover the liability, some directors extinguish their personal liability by placing the company into voluntary administration or liquidation within that notice period and before the Commissioner has an opportunity to commence proceedings to recover the debt. This often means that the full amount of PAYG withholding liabilities is never recovered. (per EM)
A better approach

- Identify revenue foregone as the result of phoenix activity as an implicit tax expenditure.
- Analyse in context of budgetary (and other relevant) criteria
- Consider whether a departure from pari passu could be justified.
- Develop legislation that addressed phoenix activity specifically and which remained consistent with original objectives of DPN regime – namely obligating payment of tax OR facilitating placement of company promptly into voluntary administration or liquidation
Conclusion

• Given contention that cost is minimal according to original report, it will be useful to determine whether this is still the case.
• Therefore, will assist in justifying pari passu in context of revenue policy.
• Will also subject the debate to a greater degree of analysis and public scrutiny.
• Should provide a more consistent policy basis on for future reform.
• Issues will be in defining loss of priority in context of the tax base etc.