Commonwealth
OMBUDSMAN

Ground Floor, 1 Farrell Place ▪ Canberra
GPO Box 442 ▪ Canberra ACT 2601
Phone 1300 362 072 ▪ Fax 02 6249 7829
ombudsman@ombudsman.gov.au
www.ombudsman.gov.au

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Mr Paul McCullough
General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr McCullough

Commonwealth and Taxation Ombudsman - comments on the *Action against fraudulent phoenix activity* Proposals Paper

I welcome the opportunity to provide comments on your *Action against fraudulent phoenix activity—Proposals paper* and the options to improve the ability of the Australian Taxation Office (ATO) and the Australian Securities and Investments Commission (ASIC) to prevent and respond to those who deliberately seek to evade tax and other liabilities.

My office has a role in dealing with complaints about the ATO and ASIC. Complaints we receive about fraudulent phoenix activity tend to relate to:

- people affected by operators who have structured their operations to avoid payment of superannuation guarantee charge
- businesses who are concerned by the ATO's apparent inability to prevent phoenix activity
- concerns that ASIC has not exercised its power to disqualify a person, involved in a failed company, from managing a corporation.

The complaints we receive that involve phoenix operators also highlight the wider impact they can have on the community, such as on small business operators who are left as creditors of a liquidated phoenix company. This places these businesses under financial stress when attempting to meet their own obligations, including tax obligations. Complainants are further frustrated when the phoenix operator is known to the ATO and ASIC but continues to engage in the conduct with no apparent sanction applied.

I support strengthening the powers of the ATO and ASIC to prevent and respond to fraudulent phoenix behaviour. Reducing the incentive to engage in fraudulent phoenix operations would help prevent losses to the broader community and would increase public confidence in the integrity of the tax system. The options canvassed in the Proposals paper would better enable the ATO and ASIC to deal with problems across the full spectrum of phoenix activity. Our complaints have shown that while operators of smaller companies might incur smaller liabilities and therefore can be seen as a relatively lower risk, the impact on individual employees who are not paid their entitlements can be significant. We also acknowledge, as does the Proposals paper, the need to balance the strengthening of powers to deal with such activity with requirements to ensure that legitimate business activities are not penalised.

The Proposals paper reflects the range of problems caused by the fraudulent phoenix activity we see in complaints - particularly in relation to unmet superannuation guarantee obligations

Below are my comments on the options in the Proposals paper. These comments are directed at the reform options which would be enforced administratively by the ATO or ASIC, as these are the areas that arise most frequently in our complaints.

Automating director penalties

The paper proposes to amend the director penalty regime to automatically apply a parallel liability to directors of companies whose Pay As You Go Withholding (PAYG (W)) liability remains unpaid for a period of time (three months is suggested as an option).

There would be benefits from this 'automation' of director penalties in deterring operators who are directors from engaging in phoenix activity as well as making it easier and more cost effective for the ATO to administer the penalties. 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.

The Proposals paper appropriately recognises the possible need for limitations on the operations of an automated director penalty regime. I recently released an issues paper highlighting the need to consider the potential for unforeseen and harsh consequences to arise from legislation.[1] There would be merit in including a review mechanism in any such mechanism to enable the ATO to consider cases where the liability is disputed and to exercise discretion to remove the penalty in unexpected and deserving cases.

It is also important to consider the information that is provided to directors. As this proposed measure is not specifically targeted at identified phoenix risks and directors may have varying levels of access to information about company accounts, it would be appropriate for the ATO to send notices to directors informing them when penalties have been applied. This is particularly important because director penalty accounts are not necessarily available to directors or their agents electronically and those who cease to be company directors will have no access to information about the outstanding amount of their liability.

I would also encourage any decision about whether and how to automate the director penalty regime to take into account the Australian Government's *Better Practice Guide to Automated Assistance in Administrative Decision-Making*.[2] This provides useful guidance for taking into account administrative law principles in determining whether and in what form automation is appropriate.

Expanding the director penalty regime

I support the expansion of the director penalty regime to other liabilities such as GST and excise and in particular the superannuation guarantee charge. This would be consistent with the priority that superannuation guarantee debts are awarded in liquidation and in ATO payment allocation policies.

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1 Commonwealth Ombudsman, *Mistakes and unintended consequences — a safety net approach,* Issues Paper November 2009

[2] Australian Government, *Automated Assistance in Administrative Decision-Making better practice guide*, February 2007 (available from the Ombudsman website at http://www.ombudsman.gov.au/pages/publications-and-media/better-practice-guides/)

Last financial year, around 10% of our complaints about taxation administration were about the ATO's inability to recover unpaid superannuation. If superannuation was included in a director penalty regime, the ATO may have been able to recover unpaid superannuation in the following cases.

Phoenix arrangement stymies ATO recovery of unpaid superannuation
Case 1
Ms X complained about the ATO's inability to recover her unpaid superannuation. She had worked as a receptionist for a small company for many years and was owed around $50,000 in unpaid superannuation. The ATO raised a debt against her employer. Her employer then changed the name of the company and went into voluntary liquidation. The ATO lodged a proof of debt but was advised by the liquidator that no dividend would be paid. The ATO finalised its recovery process by advising Ms X that it was not able to recovery any of the money owed to her. Ms X's former employer then continued to trade in the same profession using the original company name.

Case 2
We investigated a complaint from several employees about unpaid superannuation guarantee amounts by the operator of a number of business entities.

The affected employees worked for a business that was bought by an operator who ran the business through a company as trustee for a trust. Subsequently a new company was formed for the purpose of providing administrative services to the business. Employees reported their concerns that their superannuation entitlements were not being paid.

The operator was able to avoid ATO action to recover the unpaid superannuation and other tax liabilities by shifting arrangements between companies and ceasing to be a director and secretary when the ATO made enquiries about company liabilities. The business maintained continuity in the trading name and operated from the same registered office and principal place of business under different company structures.

The ATO issued assessments against the employing company for unpaid superannuation. The company went into liquidation after an administrator was appointed. The administrator reported that the former director of the liquidated company was also the director of the new company that purchased the assets of the liquidated company. Before these events ASIC had disqualified him from taking any part in managing corporations. The new company trades under the same name from the same business address.

I also support the option in the Proposals paper to re-introduce an offence for non-remittance of PAYG (W) amounts as well as the creation of a similar offence for failure to comply with superannuation guarantee obligations.

Expanding scope for disqualification of directors

The paper proposes to remove the requirement, at s 206F of the *Corporations Act 2001* (the Corporations Act) that a director has managed two or more failed corporations, before ASIC can disqualify a director. I note that s 206F requires ASIC to take into account whether companies are related in making this assessment. We have found, in our investigations of complaints, that ASIC's interpretation of this has been that if companies were related, it would consider that the officer had not been an officer of two distinct companies and, therefore, that it could not exercise its power under s 206F to disqualify that person from being a director. This approach was also noted by the Australian National Audit office in its 2007 report *ASIC's Processes for Receiving and Referring for Investigation Statutory Reports*

of Suspected Breaches of the Corporations Act 2001. The ANAO legal advice indicated that the relationship between the companies, while a necessary factor to take into account, was still only one factor relevant to the decision and not of itself conclusive. As phoenix activities are likely to involve related companies, the proposal to remove this requirement should make ASIC's use of this power more effective.

Our investigation of complaints about cases where ASIC has not exercised its power to disqualify a person from managing a corporation has also shown the considerable extent to which ASIC relies upon the statutory reports of liquidators in making decisions to exercise its powers under s 206F. We have investigated complaints where liquidators have advised ASIC that they have insufficient funds to make the necessary inquiries to draw conclusions about the conduct of directors. As a result, the subsequent liquidator's statutory reports do not contain sufficient evidence for ASIC to make a decision on the issue of disqualification.

I note that liquidators can access the Assetless Administration Fund (the Fund) which is administered by ASIC and finances preliminary investigations and reports by liquidators into failed companies with few or no assets with a focus on curbing fraudulent phoenix activity. While ASIC does advise liquidators of the existence of the Fund, it does not, to our knowledge, provide assistance in making applications to the Fund. It appears that the take up rate for the Fund has been low in recent times. One reason suggested for this is the cost of the work involved in the application process, which reduces the value of any assistance that may be provided by the Fund. It is important therefore that necessary resources are made available to obtain the relevant evidence to support any expanded power.

Need for stronger powers to be supported by robust decision-making

The Proposals paper highlights the inherent difficulty in determining when liquidation of corporations is unfair and dishonest as opposed to being a necessary and appropriate action to avoid insolvent trading. It is important that the decision making processes which identify inappropriate phoenix activity are robust and transparent. Decisions should be based on clear criteria, be documented and be subject to review.

Determining the difference between a company that is struggling financially and a potential phoenix risk is not always clear as the following case shows.

When is a company a phoenix risk?
We investigated a complaint, from a company operating a small business, about the ATO's decision to garnishee over $100,000 from its account. This left the company account almost empty and unable to pay for materials for its next job.

The company had missed a payment due to the ATO and had not always made instalments under its payment arrangement on the agreed date. The ATO had identified the company as a phoenix risk because the director had previously operated another company with tax debts that had gone into liquidation. The director did not dispute this but said he had done this to avoid trading while insolvent and he was also a significant creditor to the liquidated company. Other than this the director did not have a previous history of company liquidation.

The ATO had contacted the company as part of its Phoenix Early Intervention Strategy. This had been successful with the company paying the missed payment immediately and being on track with instalment payments. However, the ATO issued the garnishee notice for the remaining amount of the payment arrangement because it decided that the risk of the company liquidating was too high. While the company had been non-compliant, the case demonstrates the need for clear and documented decision-making where strong penalties are being applied to a company as a preventative measure.

Thank you for the opportunity to comment on the Proposals paper. If you have any queries about this response, please contact Ms Diane Merryfull on (02) 6276 0177.

Yours sincerely

Prof John McMillan
Commonwealth and Taxation Ombudsman