



Australian Government

COMBATTING ILLEGAL PHOENIXING

September 2017

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Manager
Editorial, Media and Speeches Unit
The Treasury
Langton Crescent
Parkes ACT 2600
Email: medialiaison@treasury.gov.au

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CONSULTATION PROCESS

REQUEST FOR FEEDBACK AND COMMENTS

The questions in this consultation paper aim to frame discussion however, they are not intended to limit consideration of related and relevant matters.

Non-confidential submissions may be made available on the Treasury website. Submissions made in confidence will not be published. A request for access to a confidential submission will be determined in accordance with the *Freedom of Information Act 1982* (Cth).

In the absence of a clear indication that a submission is intended to be confidential, a submission will be treated as non-confidential.

Closing date for submissions: 27 October 2017

Email phoenixing@treasury.gov.au

Mail James Mason
 Financial System Division
 The Treasury
 Langton Crescent
 PARKES ACT 2600

Enquiries Enquiries can be initially directed to James Mason.

Phone (02) 6263 4405.

The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate.

FOREWORD



Phoenixing involves the stripping and transfer of assets from one company to another to avoid paying liabilities. It hurts all Australians, including employees, creditors, competing businesses and taxpayers, and has been a problem for successive governments over many decades.

Phoenixing has a significant financial impact – in 2012, the Fair Work Ombudsman and PwC estimated the cost of phoenixing to the Australian economy to be as high as \$3.2 billion annually. It also undermines business' and the public's confidence in the corporate and insolvency sectors and the broader economy.

Companies fail for many different reasons, and it can be difficult to distinguish between those who are engaging in illegal phoenix activity and those who are simply involved in a failed company. We are committed to helping honest and diligent entrepreneurs who drive Australia's productivity, but we won't tolerate those who misuse the corporate form, to defeat creditors and rip off all Australians.

Phoenixing behaviour is becoming increasingly sophisticated and difficult to detect and deter within the existing legal and regulatory framework.

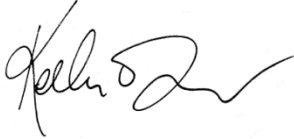
To address this, the Government is consulting on options for implementing a range of measures to deter and disrupt the core behaviours of phoenix operators, including non-directors such as facilitators and advisers. These are based on the recommendations of the Government's Phoenix Taskforce. The Government recognises the need for carefully targeted reforms which minimise any impact on legitimate business activities and honest business restructuring.

These reforms will complement other Government action we have already taken, including:

- instituting the Phoenix, Black Economy and Serious Financial Crime Taskforces;
- strengthening disciplinary rules for insolvency practitioners;
- legislating to improve information sharing between key regulatory agencies;
- reviewing and enhancing ASIC's powers and enforcement tools;
- consulting on law reform initiatives to curb the excessive drain on the taxpayer funded Fair Entitlement Guarantee scheme, which covers employees' entitlements left outstanding as a result of failed business enterprises;
- improving the collection of GST on new residential premises and residential subdivision transactions from 1 July 2018;
- phasing in near real-time reporting by employers of payroll and superannuation information to the ATO through the single touch payroll reporting framework, giving the ATO improved visibility over employers' compliance with their tax obligations including the superannuation guarantee;
- consulting on a register of beneficial ownership for companies, to be made available to key regulators for enforcement purposes; and
- developing and improving legislation to encourage and protect whistleblowers.

As part of its anti-phoenixing agenda, the Government is engaging with key stakeholders on the introduction of a Director Identification Number (DIN). A DIN will allow enforcement agencies to verify and track the current and historical relationships between directors and the entities they are associated with.

The Government seeks your views on the options for law reform outlined in this paper and encourages you to participate in the consultation process.

A handwritten signature in black ink, appearing to read 'Kelly O'Dwyer', with a stylized flourish at the end.

The Hon Kelly O'Dwyer MP
Minister for Revenue and Financial Services

BACKGROUND

The Australian Government has committed to ongoing reform of Australia's corporate insolvency regime. This paper is seeking feedback on a package of measures aimed at countering illegal phoenixing, and which are intended to form the Government's third tranche of insolvency law reforms.

The first tranche, contained in the *Insolvency Law Reform Act 2016*, modernised the corporate reorganisation framework around the registration, remuneration and regulation of insolvency practitioners to improve confidence in the corporate insolvency regime and reduce associated costs.

The second tranche, introduced as part of the National Innovation and Science Agenda (NISA), focussed on supporting honest business restructuring. The *Treasury Laws Amendment (2017 Enterprise Incentives No.2) 2017 Act* introduced a safe harbour for directors from personal liability for insolvent trading if the company is undertaking a restructure outside formal insolvency. From 1 July 2018, it will also make ipso facto clauses (that allow contracting parties to immediately terminate agreements with a company when an insolvency event occurs) unenforceable if the company is undertaking a formal restructure.

The measures which are the subject of this Consultation Paper build on other action taken by the Government to combat crime and fraud occurring in the economy, including strengthening disciplinary rules for insolvency practitioners and legislating to enable information sharing between key regulatory agencies. The proposed measures also compliment the recently announced package of reforms that target employers who fail to meet their superannuation guarantee obligations.

WHAT IS ILLEGAL PHOENIX ACTIVITY?

Phoenix activity is not defined in legislation and can encompass both legitimate business rescue activities and the use of serial insolvency as a business model to avoid debts and even in some cases to facilitate money laundering.

For ease of reference, this paper will refer to legitimate phoenix activity as "honest business rescue". Honest business rescue is a legitimate use of the corporate form, whereas illegal phoenixing is a misuse of the corporate form, which seeks to exploit the privilege of limited liability.

While the scale of illegal phoenixing ranges from the opportunistic to the systemic, its common characteristic is that when a company is unable to pay its debts, its controlling directors act in a manner which denies creditors access to the entity's assets to meet the unpaid debts.

THE IMPACT OF ILLEGAL PHOENIXING

Historically, quantifying the impact of phoenixing has been problematic. The 'Phoenix Project' led by Professor Helen Anderson as a joint research project of the University of Melbourne and the Monash Business School has noted that "[i]llegal phoenix activity is not subject to precise modelling..."¹ and that "...at present, the inconsistencies and gaps in datasets relating to the incidence, cost, and enforcement of laws tackling illegal phoenix activity render its accurate quantification impossible."²

While it is difficult to quantify its impact, according to the Fair Work Ombudsman and PwC, in 2012, the cost of illegal phoenix activity was estimated to be in the range of \$1.8 to \$3.2 billion per year.³

Those affected by illegal phoenix activity include employees of the original failed company, other businesses and contractors who are owed money because they have supplied goods and services and statutory bodies like the Australian Taxation Office (ATO). Non-payment of employee entitlements and company tax hurts not only the affected employees, but all Australian taxpayers via resulting Fair Entitlement Guarantee payouts, and increased taxes for the general population. It also gives phoenix companies an unfair advantage over their competitors.

What is known is that illegal phoenix activity has a widespread impact through:

- avoidance of debts to creditors (particularly unsecured creditors);
- unfair profit and contract/tender winning advantage over other businesses;
- loss of market integrity and confidence in corporation law regime;
- avoidance of employee entitlements including wages, superannuation, accrued leave;
- misuse of the Fair Entitlements Guarantee Scheme;
- non-remittance of pay-as-you-go withholding (PAYGW) and GST payments, and avoidance of income, pay-roll and other taxes;
- increased costs to regulators; and
- negative economic and social impacts, particularly at a local and regional level.

ILLEGAL PHOENIXING IS EVOLVING

Illegal phoenix activity is a learned and sometimes facilitated behaviour, and its nature is constantly changing.

In some instances, illegal phoenixing may be opportunistic, where the intention to avoid debts is only formed as the company starts to fail. In other cases, phoenix operators may set up businesses with

1 "Defining and Profiling Phoenix Activity", Helen Anderson, Ann O'Connell, Ian Ramsay, Michelle Welsh and Hannah Withers, (Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, December 2014, p2).

2 Helen Anderson, Ann O'Connell, Ian Ramsay, Michelle Welsh and Hannah Withers, *Quantifying Phoenix Activity: Incidence, Cost, Enforcement* (Melbourne Law School and Monash Business School, October 2015), p. 84.

3 "Phoenix activity: Sizing the problem and matching solutions" PwC and Fair Work Ombudsman, page 15, June 2012

the intention that they will ultimately fail, and use complex corporate structures to facilitate their plans.

Two particular trends have been the focus of regulators and agencies:

1. The facilitation of illegal phoenix activity by dishonest and predatory pre-insolvency advisers; and
2. The increasing use of sophisticated structures where phoenixing becomes part of the business model.

Pre-insolvency advisers facilitate illegal phoenix activity

A well-functioning financial system should provide directors of distressed companies with easy access to advice to assist them to make critical decisions about the future of their company.

The adviser market has grown substantially over the past decade and evidence shows that advisers other than professionals, such as lawyers and registered liquidators, are increasingly undertaking work in the Small & Medium Enterprise (SME) space. Traditionally, professionally qualified people who are subject to legislative requirements and disciplinary action by regulators and relevant professional bodies undertook the bulk of this work.

Many SME advisers provide appropriate and valuable assistance to directors when their companies are in financial difficulty, and can help turnaround a business in difficulty.

However, while most advisers are qualified and reputable, some 'pre-insolvency advisers' are not, and this is compounded by the fact that most are unregulated and unlicensed.

A director, concerned about his or her company's financial position can easily access a range of parties offering pre-insolvency advice, and these directors are often vulnerable to offers of assistance from predatory advisers.

The Phoenix Taskforce has reported that increasingly pre-insolvency advisers may approach the directors of a company in financial difficulty and suggest phoenix activities as a way to save the underlying business. These advisers then conduct asset sales or restructures aimed at defeating creditors' interests, thus leaving an assetless company for the subsequently appointed liquidator to wind up.

The actions of these unscrupulous, rogue advisers robs creditors and employees of their due claims and can expose unwitting directors to claims for breaches of their directors' duties.

ILLEGAL PHOENIXING IS GETTING MORE SOPHISTICATED

In more sophisticated cases, phoenix activity is adopted as a business model, where companies are formed with the intention that the company's debts will never be paid, and the company's assets will be transferred to another company, in due course.

Common illegal phoenix activities include:

- lodgement of Business Activity Statements (BAS) after the company becomes insolvent to obtain a refund of GST input credits, where expenses precede receipts. This activity is common in certain industries, such as property construction;
- non-lodgement and non-payment of BAS and income tax returns;
- non-payment of certain unsecured creditors;
- non-payment or manipulation of employee entitlements, including Superannuation Guarantee payments;
- non-payment of ASIC fees; and
- under-declaration of staff numbers or payments to state regulators (payroll tax, workers' compensation).

Phoenix operators may also create complex corporate structures to group assets in certain subsidiaries, whilst siphoning liabilities into other subsidiaries, which can subsequently be placed into liquidation.

CURRENT RESPONSES TO PHOENIXING

Historically, illegal phoenixing has been tackled on an ad-hoc basis by individual regulators. This has delivered only limited success because, even where enforcement action is successful, individual regulators are not adequately equipped, on an individual level, to address the problem of illegal phoenix activity.

In order to develop an effective, whole-of-government response to the illegal phoenixing problem, the Government established a number of taskforces to facilitate cross-agency co-operation and enforcement.

THE GOVERNMENT'S TASKFORCES

The Government established the Phoenix Taskforce in 2014, and the Serious Financial Crimes and Black Economy Taskforces in 2015 and 2016 respectively. The Taskforces have each focussed on combatting illegal phoenixing and have provided extensive advice to Government.

Serious Financial Crimes Taskforce

The Serious Financial Crime Taskforce (SFCT) is part of the Australian Federal Police-led Fraud and Anti-Corruption Centre. The Taskforce, which includes the Australian Securities and Investments Commission (ASIC), the Australian Transaction Reports and Analysis Centre (AUSTRAC), the ATO and other Commonwealth agencies, is responsible for investigations and prosecutions for serious and complex financial crimes including illegal phoenix activity.

Black Economy Taskforce

The Government established the Black Economy Taskforce to develop an innovative, forward-looking and whole-of-government policy response to combat the black economy in Australia. The Taskforce

is chaired by Mr Michael Andrew AO, former global head of KPMG and current Chair of the Board of Taxation.

The Black Economy Taskforce has been considering the phoenixing problem in its review.

The Taskforce canvassed a number of reforms in its *Interim Report and Additional Policy Ideas* consultation paper to help counter the phoenixing problem, including identity related initiatives, reforms to the Australian Business Number system and government procurement. The Taskforce's final report is due to the Government by the end of October.

Phoenix Taskforce

The Government's on-going Phoenix Taskforce comprises over 20 Federal, State and Territory government agencies and provides a whole-of-government approach to combatting illegal phoenix activity.

The Phoenix Taskforce is a crucial player in countering illegal phoenix activity, and has provided a confidential report to the Government which shows that the detection, deterrence and disruption activities undertaken by Phoenix Taskforce agencies are starting to have an impact on the problem. However, the Phoenix Taskforce has also concluded that there is scope for the existing laws to be amended to better address phoenix activity.

WHY WE ARE CONSULTING

The steps involved in illegal phoenixing may be largely identical to those involved in honest business rescue. The difference between illegal phoenixing and honest business rescue (or restructure) activities largely hinges on the question of whether the company's controllers' intent is genuine and honest or illegitimate – namely to avoid payment of liabilities. This is difficult to prove to the requisite legal standard.

Historically, attempts to define 'illegal phoenix activity' have proved either too narrow and thus easily avoided, or too wide, thus capturing legitimate business rescues.

Current legislation lacks the strategic design to effectively deter and combat increasingly sophisticated phoenix activity. The existing regulatory toolkit is resource intensive and inefficient and focuses too heavily on enforcement and prosecution rather than deterrence.

New tools are needed to combat phoenixing in an efficient and timely manner to protect creditors, competitors, employees and Australian taxpayers.

THE AIM OF THE PROPOSED REFORMS

This Consultation Paper seeks feedback on a number of law reform proposals which are based on recommendations made by the Government's Phoenix and Black Economy Taskforces.

The aim of the reforms is to deter and disrupt illegal phoenix activity and remove the unfair competitive advantage that flows from this, while minimising any unintended impacts on legitimate businesses and honest restructuring.

Combatting Illegal Phoenixing

The measures we are consulting on propose certain changes to assist the regulators to better target those who repeatedly misuse corporate structures, and to enable them to take stronger action against those individuals.

The paper sets out a number of possible changes to the current corporations and taxation laws to support the Government's anti-phoenixing agenda.

The paper seeks submissions on whether these changes should be adopted wholly, or in part, or if other changes are necessary or desirable to better address the problem of illegal phoenixing.

The amendments proposed to the law target illegal phoenix activity, both those who engage in it and those who facilitate it. The reforms set out in this paper are intended to complement and support other Government actions in this area, and strike an appropriate balance between deterring and disrupting illegal behaviour, whilst supporting innovation and entrepreneurialism.

Accordingly, while some of the law reform proposals in this paper will impact the entire corporate and taxation framework (Part One), there are a number of law reforms which will be tightly targeted at only those involved in the most egregious phoenix activity (Part Two).

PART ONE – BROAD REFORMS

1. IDENTIFYING ILLEGAL PHOENIX ACTIVITY – A PHOENIX HOTLINE

Current situation

Several agencies such as ASIC and the ATO operate ‘hotlines’ or similar systems that allow the public to communicate concerns, including in relation to illegal phoenix activity.

While there are increasing levels of co-ordination between agencies, it is possible that information reported by members of the public, employees, or creditors is not well matched with a report about the same phoenix operator from a different source reported to another agency.

Further, even if two agencies do match independent reports of information, there is not necessarily a strong mechanism to ensure that other relevant agencies with an interest in the information will receive a copy of the information.

Proposed reform

The Phoenix Taskforce has developed a robust distribution mechanism to allow for information from the members of the Taskforce to be collated and shared.

To help in the collation and distribution of information, the ATO, or whichever agency is best placed to do so, could operate a singular ‘phoenix hotline’ such that any information reported by the community about phoenix concerns could be shared with all members of the Taskforce.

The ‘hotline’ itself may be one or more of many channels, including telephone, e-mail, smartphone application and physical mail to accommodate the entire community.

Best practice would mean that persons providing information to the ‘hotline’ could do so anonymously if they wished.

Transparency and public confidence could be improved through public reporting on information provided through the hotline.

Most typically, the operational protocols of the various members of the Phoenix Taskforce would not allow a person who provided information to be informed about how or when such information was used, and, if the information was provided anonymously, there would be no capacity to do so.

QUESTIONS

1. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
2. Are there any other reporting mechanisms which you think would assist people to report suspected illegal phoenix activity?
3. What are the benefits and risks of a 'phoenix hotline'?
4. Which agency do you believe would be best placed to operate such a hotline?
5. What public reporting would be appropriate to ensure transparency? What other mechanism could be considered?

2. A PHOENIXING OFFENCE

Limited liability is a cornerstone principle of corporate law in Australia, and many other foreign jurisdictions. It is crucial to the economy by playing an important role in encouraging productive risk-taking and fostering entrepreneurialism.

The steps involved in the illegal phoenixing of a company – for example the formation and liquidation of a company and the transfer of assets to another entity – are largely identical to those involved in the honest rescue of a business.

It is the avoidance of paying creditors, tax and employee obligations, particularly where there is dishonesty, that distinguishes illegal or fraudulent phoenix activity from honest business rescue.

Current situation

Currently there is no specific offence for illegal phoenix activity, but conduct which constitutes illegal phoenix behaviour is generally a civil and or criminal breach of a director's statutory duties.

The issue of introducing a specific offence for phoenixing has been the subject of much debate, largely centred around the problem of clearly delineating the offence so that it does not inadvertently capture legitimate transactions and business restructures.

Rather than attempting to define a phoenixing offence, the Government is seeking to target certain common illegal phoenix behaviour.

Proposed reform – a specific phoenix offence

This proposal seeks to target the common illegal phoenix behaviour of transferring a company's assets to a new entity, with the intention or effect of defeating the claims of creditors of the original company.

It is proposed to amend the *Corporations Act 2001* (Corporations Act) to specifically prohibit the transfer of property from Company A to Company B if the main purpose of the transfer was to

prevent, hinder or delay the process of that property becoming available for division among the first company's creditors.

This could operate in a similar manner to the provision set out in section 121(1) of the *Bankruptcy Act 1966*, which states that the main purpose in making the transfer will be taken to be the prescribed purpose, "*if it can reasonably be inferred from all the circumstances that, at the time of the transfer, the transferor was, or was about to become, insolvent*".

Rebuttable presumptions of insolvency would apply, and such a transaction would be void against a liquidator (so that the assets can be clawed back in liquidation).

The offence would give rise to a right in creditors and liquidators (and ASIC) to sue for compensation for the loss caused by the conduct of those who engage in the prescribed conduct as well as those who are knowingly involved in that conduct under section 79 of the Corporations Act.

Similar defences to those available under section 121(4) of the Bankruptcy Act would be available (regarding payment for the property, knowledge of the main purpose of the transfer and inability to infer that the transferor was or was about to become insolvent at the time of the transfer).

One of the significant difficulties in bringing an action against directors in relation to illegal phoenix activity (for both ASIC and for liquidators) is demonstrating that the transferred assets were in fact originally the property of Company A, and that Company B did not pay proper consideration for them.

Section 139ZQ of the Bankruptcy Act allows the Official Receiver to send a notice to a person who the Official Receiver considers has received property in contravention of section 121, demanding payment of money for the value of the property received. The notice is required to set out the facts and circumstances pursuant to which the Official Receiver considers that the transaction is void against the trustee.

It is proposed that where ASIC (or a liquidator) suspects that illegal phoenix activity has occurred and that assets of Company A have been transferred to Company B for no or less than their market value:

- ASIC may issue a notice upon Company B (either on ASIC's behalf or at the request of a liquidator who is able to satisfy ASIC as to the matters above) requiring that Company B deliver up property or monies' worth, along the lines of the regime in place under section 139ZQ of the Bankruptcy Act; and
- the recipient of the notice would have the right to apply to court to set aside the notice.

Such a regime may significantly assist in pursuing illegal phoenix activity because it would greatly reduce the cost of either taking action to recover the property or to seek compensation for the loss suffered.

QUESTIONS

6. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
7. What are the benefits and risks of this approach?
8. Should ASIC retain control of the issuing of such notices to ensure that they are not issued inappropriately?
9. Are there other regulators who should also be able to issue such notices (for example the Fair Entitlement Guarantee Recovery Program)?
10. Should liquidators have the ability to independently issue such notices in cases where they suspect that illegal phoenixing has taken place?
11. How long should the law allow for the recipient to respond?
12. What course of action should be pursued where the recipient fails to comply with a notice?
13. What are the some of the challenges ASIC is likely to face in seeking compliance with the notice?
14. Do you think that such an arrangement will reduce the cost of taking recovery action or seeking compensation for the loss suffered?
15. Are there safeguards which should be implemented in respect of the proposal?
16. If such a provision were to be introduced, should any of the existing voidable transaction provisions be amended or repealed?

Remedies

Any amendment to the legislation to provide clearer and more effective laws against illegal phoenix activity should also include the introduction of appropriate remedies and penalties.

Currently, ASIC may bring action against directors who breach their directors' duties, as well as those who have been knowingly involved in the breaches. Civil penalties apply to such breaches, in addition to banning orders, and ASIC has the ability to seek compensation in some circumstances.

However, banning orders, on their own, are unlikely to operate as a significant deterrent for persons who facilitate illegal phoenix activity unless they manage corporations, and may not have much of an effect on some directors (who can go on to manage corporations through other persons).

Furthermore, compensation orders and civil penalty orders may not be a significant deterrent in circumstances where persons who typically engage in and facilitate illegal phoenix activity often have few assets in their own names.

In implementing the above offence, the Government is considering whether:

- both liquidators and ASIC should be able to claw back assets or compensation from the transferee;
- liquidators, ASIC and creditors should be able to pursue compensation for the loss caused by illegal phoenix activity from directors of the transferor, the transferee, and from others who are knowingly involved in the illegal phoenix activity; and
- civil and criminal penalties should apply to illegal phoenix activity, including against those who are knowingly involved in illegal phoenix activity.

QUESTIONS

17. Are these remedies appropriate? Are there further remedies or penalties we should consider?
18. If the above amendments are made, should the law also be amended to include a specific provision to the effect that knowing involvement in a contravention of the provision will itself constitute a contravention of the provision (as per sections 181 — 183 of the Act)?
19. What tests can be applied to determine if a person has been involved in the facilitation of illegal phoenix activity?

Proposed reform – designating breaches of existing provisions as phoenix offences

The Corporations Act contains numerous offences which are commonly breached by those involved in phoenix activity.

For example, section 286(1) states that a company must keep written financial records that:

- correctly record and explain its transactions and financial position and performance, and
- would enable true and fair financial statements to be prepared and audited.

The Corporations Act also imposes obligations to assist an administrator, liquidator or controller in a formal insolvency.

A key element of most illegal phoenix activity is the failure to maintain adequate books and records, and failure to provide them to an insolvency practitioner in a formal insolvency.

It is proposed that breaches of these provisions would be made 'designated phoenix offences', where instances of a breach could result in a director of a company being deemed a Higher Risk Entity (see section 8).

It is also proposed that the law be amended so that knowing involvement in a contravention of a phoenixing provision will itself constitute a contravention of the provision.

QUESTIONS

20. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
21. Which existing breaches of the law, if any, should be designated as phoenix offences?

3. ADDRESSING ISSUES WITH DIRECTORSHIPS

Current situation – appointment and resignation

Currently under the law, a proprietary company must have at least one appointed director that ordinarily resides in Australia and is at least 18 years of age, and a public company must have at least three appointed directors of which two must ordinarily reside in Australia.

Generally a director may resign by giving notice of the resignation to the company. Director resignation is unilateral, and the company does not need to agree to the resignation for it to be effective.

The resignation of a director is generally a matter dealt with by the company's constitution, which most commonly stipulates that a director must resign in writing.

Currently under the Corporations Act a company has the responsibility of lodging a notice with ASIC informing them of a director's appointment or resignation within 28 days of it occurring. Although the Corporations Act provides discretion for directors to lodge notice of retirement with ASIC, it does not stipulate a time period within which a director must notify the company of their retirement or resignation.

The lodgement of a notice with ASIC that a director has resigned by necessity occurs after the fact, and a discrepancy can arise where a director alleges that a resignation notice was provided to the company, but the company has not communicated this to ASIC, as it is the company, not its former director, who has liability for proper record keeping and making necessary ASIC lodgements.

How phoenix operators exploit the current law

Illegal phoenix operators exploit the current law by ensuring that the company (electronically or via paper copy, through an agent or directly) lodges the appropriate ASIC form noting a change of director, but the notice backdates the director's resignation so that the director cannot be held liable for offences committed after that time.

Similarly, a company may backdate the commencement of a different 'dummy' director prior to the period where some offending conduct has occurred, to shield the real controller of the company. In some cases, this dummy director may be a fictitious, deceased, or transient person who cannot be found, and/or a person who has no financial means.

Proposed reform: limiting backdating of director appointments and resignations

This proposal would involve amending the Corporations Act to impose a rebuttable presumption that where a change in director notice is lodged more than 28 days (or another suitable period) after the date of the director's resignation, the director could still be held liable for misconduct that had occurred up to the point of lodgement.

The presumption could be overturned on application to the court or at the provision of appropriate information to the satisfaction of ASIC.

Additionally, the onus for reporting director resignations could be shifted from the company to the individual resigning director.

This would ensure that the responsibility attaches to the resigning director so the director can't abrogate this to the company, which may be nothing more than an empty corporate shell.

QUESTIONS

22. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
23. Do you agree that there should be a rebuttable presumption that a director should still be held responsible for misconduct if the required notice is not lodged with ASIC in a timely way?
24. What are the benefits and risks of this approach?
25. What is a reasonable period to allow for the requisite notice to be lodged with ASIC?
26. Should the onus for reporting to ASIC be placed on the individual director, rather than the company? If so, would this constitute a significant compliance burden?
27. How should the above measure be enforced? For example, by application to court or ASIC taking other administrative action?

Current situation - abandoning a company

Because a director can resign unilaterally, this can lead to a situation where a sole director resigns from their directorship but does not advise ASIC of their resignation and the company is left without a natural person's oversight.

As a result, the company may not make the necessary director resignation lodgements with ASIC, and nor can it appoint a replacement director. The company is thus abandoned until such time it is placed into external administration by a creditor via court proceedings or is deregistered or administratively wound up by ASIC.

How phoenix operators exploit the current law

A phoenix operator may undertake trading for a period of time with no directors in place, strip the company of any assets, leave behind unpaid debts, and place the company into external administration.

Although ASIC may deregister a dormant company if it believes the company has ceased trading or has outstanding fees and penalties, there is currently a significant time delay which can be exploited by phoenix operators to avoid the heightened scrutiny of an investigation by an administrator or liquidator.

Proposed reform

The Government intends to limit a sole director's ability to resign from office without either first finding a replacement director or winding up the company's affairs by amending the Corporations Act to deem such a resignation ineffective.

In circumstances where a company has more than one director who simultaneously (or nearly simultaneously) resign and abandon a company, similar restrictions would apply.

Alternatively, abandoning a company in this manner could be made an offence.

QUESTIONS

28. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
29. Should sole directors be able to resign without appointing a liquidator or deregistering the company?
30. What are the benefits and risks of this approach?
31. Should abandoning a company instead be an offence?
32. Should a company with no director for a prescribed period be automatically deregistered? If so, what would be an appropriate period before deregistration should commence?
33. What other options are available for consideration?

4. RESTRICTIONS ON VOTING RIGHTS

Current situation

Directors initiate most external administration appointments and decide which registered liquidator is appointed as the external administrator of the company.

Depending on the type of appointment, the external administrator is obligated to hold creditors' meetings in which various resolutions pertaining to the company's affairs are passed, including a resolution confirming their appointment.

It is fundamental that creditors can remove and replace an external administrator if they are concerned that the external administrator chosen by the director will not act in their interests.

Where creditors are concerned about the external administrator's independence they may pass a resolution to remove and replace the external administrator.

Before a creditor can vote at a meeting, they must provide details of their claim to the external administrator. The Corporations Act does not prescribe the level of proof required before the person presiding at the meeting may admit a claim for voting purposes. As a result, claims are not scrutinised as much as they are when the external administrator pays a dividend.

A resolution put to the creditors' meeting to remove and replace the external administrator is decided on the voices. Alternatively, a poll may be demanded. If a poll is demanded, the resolution is passed if the majority in both number and value of creditors present vote in favour of the resolution. If there is not a majority in number and value, the person presiding at the meeting may only exercise a casting vote in favour of their removal. However, the person presiding can also choose not to exercise their casting vote, ensuring the resolution fails.

The Corporations Act defines, "related creditor". However, its scope is complex and the external administrator may have difficulty identifying whether a creditor is a related creditor (and the amount of the claim) if the company's books and records are incomplete; and particularly for voting at a creditors' meeting if the claim is made at the meeting.

Although the Corporations Act provides creditors power to remove and replace the external administrator, and apply to court for orders if the outcome is decided by related creditors, it does not prevent related creditors influencing the conduct of the external administration and frustrating the interests of creditors not related to the director or the company.

How phoenix operators exploit the current law

The current regime allows phoenix operators to "stack" votes in a creditors meeting whereby they are able to exert their influence through voting power of related creditors. Through this channel the phoenix operator can influence the outcome of proposed resolutions.

The concern that related creditors can frustrate investigations into suspected illegal phoenix activity is heightened where the external administrator's relationship with the pre-insolvency adviser or director might result in an actual conflict or the reasonable apprehension that the external administrator might not bring an impartial mind to the administration of the company's affairs.

Proposed reform

The Government is considering legislative reform to restrict the rights of related creditors to vote at creditors' meetings.

The aim is to minimise the risk that related creditors, with or without the assistance of the external administrator, can frustrate unrelated creditors – particularly where a resolution is proposed to remove and replace the external administrator.

Under this proposed measure the external administrator will be required to disregard "related creditor" votes received in relation to a resolution remove and replace an external administrator.

QUESTIONS

34. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
35. What are the benefits and risks of this approach?
36. Is the current definition of "related creditor" too broad for this purpose? If so, how should "related creditor" be defined?
37. Should related creditors that were company employees be subjected to a different treatment than, say, if they were directors? Why or why not?
38. What level of evidence should be imposed on related creditors to substantiate their respective debts?
39. Should restrictions on related creditor voting be extended to all resolutions proposed in an external administration? Why or why not?
40. Will limiting related creditor voting participation in a creditors' meeting add additional complexities to proceedings? For example quorum requirements in order to validly hold a creditors' meeting.
41. Should the above rule apply to a particular size or type of external administrations or liquidations?
42. Should the court have the power to overturn this restriction?
43. Should this restriction only be applied to certain types of companies, for example small proprietary companies?
44. Are there circumstances where this restriction should not apply?
45. What are some of the ways a related creditor might attempt to circumvent the above measure?
46. What other measures could be considered to avoid collusion between liquidators and related creditors?

5. PROMOTER PENALTIES

The current situation

The promoter penalty laws were introduced in 2006 to deter the promotion of tax avoidance and evasion schemes. In essence, the laws seek to hold accountable a person or persons who may not implement a tax avoidance scheme themselves, but who aid and abet others to do so.

The law also provides guidance on how to deal with potential breaches of the provisions. The ATO has the flexibility to seek from the Federal Court an enforceable voluntary undertaking, an injunction, or civil penalty against the promoter.

There are parties that do not undertake illegal phoenix activities themselves, but who facilitate or encourage those who undertake such activities.

How phoenix operators exploit the current law

The current promoter penalty regime relies on the existence of a tax exploitation scheme, where a scheme benefit must be derived. The existing promoter penalty law is very technical and will not always apply to those who aid or abet others to be involved in phoenix activity.

Proposed reform

Extending the promoter penalty laws to apply to promoters or facilitators of illegal phoenix activity will assist in disrupting the phoenix business model and in particular facilitators who advise or aid and abet illegal phoenix activity. The targets of these provisions may include those advisers closely involved in the design, marketing or implementation of illegal phoenix arrangements, such as unscrupulous pre-insolvency advisers, business consultants and repeat shadow directors.

This change would allow promoter penalty provisions to be used proactively to deter illegal phoenix activity – for example through enforceable voluntary undertakings where advisers undertake to provide full disclosure of their activities and to ensure their advice complies with the law.

The current promoter penalty regime could be expanded in a number of ways so that it applies to promoters of illegal phoenix activity.

Option one – broadening the current definition

One option would be to expand the scope of the promoter penalty law to apply not just to a ‘tax exploitation scheme’ to also apply to activities designed to avoid taxation obligations, including by rendering a company unable to pay its obligations.

Feedback on previous proposals to expand the definition of what constitutes a ‘tax exploitation scheme’ raised concerns that a broad definition could potentially affect innocent advisers involved in legitimate business rescue and restructuring.

These concerns could potentially be addressed by allowing a defence that mere advice provided for legitimate purposes is a protection for advisers, when corroborated by the counter-party or independent evidence.

Option two – adding a new limb to the test

As an alternative to the above option, an independent limb or third limb could be added to the promoter penalty provisions⁴ providing that an entity must not engage in conduct that results in that or another entity being a facilitator of “illegal phoenix activity” where the same test is applied as for the proposed Phoenix Offence: the transfer of property from one company to another where the main purpose of the transfer is to prevent, hinder or delay the payment of existing or expected liabilities including tax liabilities, employee entitlements and debts to creditors.

As with the existing promoter penalty laws, the proposed new limb would also apply where the arrangements were not actually implemented but would have been if not for regulatory intervention.

Option three – creating a new provision

A third option is the creation of a new provision outside of the existing promoter penalty laws similar to the provision on the promotion of illegal early release of superannuation benefits.⁵ This provision applies to promoters of schemes that incorrectly offer people early release from their preserved superannuation benefits prior to retirement without meeting the statutory conditions for such release. Offences can attract civil penalties or criminal prosecution. This activity undermines the Government's retirement income policy and exploits vulnerable people within the community.

4 In Division 290 of Schedule 1 to the *Taxation Administration Act 1953*.

5 See section 68B of the *Superannuation Industry (Supervision) Act 1993*.

QUESTIONS

47. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
48. Should the promoter penalty laws be expanded to apply to promoters or facilitators of illegal phoenix activity?
49. What are the benefits and risks of this approach?
50. If the promoter penalty laws are expanded to illegal phoenix activity, how would they best be structured? For example by adding a new limb to the existing provisions or creating a separate new provision?
51. Are there additional safeguards that would be needed to ensure innocent advisers are not caught by the provisions? Is the defence to show that mere advice was provided, independently verified, appropriate protection?
52. If promoter penalties are expanded to apply to promoters of illegal phoenix activity, do the existing sanctions provide sufficient deterrent?
53. Are the offences of civil penalty and criminal prosecution available under section 202 the *Superannuation Industry (Supervision) ACT 1993* preferred to the promoter penalty options above?
54. An alternative approach to stop the promotion or facilitation of illegal phoenix activity may be a Court order to require specific performance of some action, for example, submitting a company liquidation proposal for consideration by ASIC. Is there merit in this or alternate approaches to effectively deter those who promote or facilitate illegal phoenix activity?

6. EXTENDING THE DIRECTOR PENALTY NOTICE REGIME TO GST

Current situation

Currently, the Director Penalty Notice (DPN) regime only applies to pay-as-you-go withholding (PAYGW) and to compulsory superannuation contributions (through the collection of super guarantee charge (SGC)). It does not apply to a company's unpaid GST liabilities.

How phoenix operators exploit the current law

Companies can fall behind in paying GST to the ATO, and directors can deliberately exploit the time between collecting GST and the due date for paying it to the ATO. Non-compliant businesses, including those that are engaged in phoenixing, claim GST input tax credits for their costs and expenses, collect GST from customers, do not report their liability to the ATO and then liquidate the company pocketing the GST for personal gain. Compliant companies are at a competitive disadvantage with non-compliant companies, which are able to undercut prices knowing that GST collected will not be paid to the ATO.

Proposed reform

Extending the DPN regime to include companies' outstanding GST obligations will allow the ATO to recover penalty amounts equivalent to the GST. Directors of these companies would be personally liable to pay a penalty equivalent to the amount of unpaid GST. The proposed expansion would apply to all directors. The penalty would be discharged in accordance with same rules that apply to PAYGW and SGC penalties as outlined above.

This proposal is designed to act as a financial disincentive to engage in illegal phoenixing behaviour. The proposal complements other phoenixing measures to remove pathways by which phoenix operators seek to obtain an unfair personal advantage. This proposal also assists to level the playing field with compliant companies competing with companies run by phoenix operators, removing one tool such companies use to reduce prices.

The proposal complements and builds on other Government action to strengthen GST compliance – namely, requiring purchasers of newly constructed residential properties or new subdivisions to withhold GST.

QUESTIONS

55. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
56. What are the benefits and risks of this approach?
57. Should the DPN regime be expanded to cover GST for all directors, or be restricted to those identified as High Risk Phoenix Operators (see Part Two)?
58. Are there alternative approaches to securing outstanding payment of GST from companies and their directors?

7. SECURITY DEPOSITS

Current situation

Under the tax law, the ATO can require a bond or other security from a business for existing or future tax liabilities that are at high risk of not being paid⁶. High risk situations are those where the ATO believes that the taxpayer will carry on an enterprise for a limited time only, or that is otherwise appropriate to request a security.

The ATO may consider a number of relevant factors before requesting security, including the nature of the enterprise and the taxpayer's current or future tax liabilities, compliance and payment history, other financial liabilities and debtor arrangements and ability to pay.⁷

6 Section 255-100 of Schedule 1 to the *Taxation Administration Act 1953*.

7 Law Administration Practice Statement PS LA 2011/14 General debt collection powers and principles, paragraphs 98-105.

Examples of high risk situations include businesses, their directors and associates, with a history of non-compliance or past phoenixing, and businesses created in Australia by foreign business people who plan to leave the business with unpaid tax debts.

How phoenix operators exploit the current law

Although the security could be in any form, the ATO usually demands a charge, lien or a mortgage over an asset. The security provided will secure the tax debt that is owing or likely to be owed in the future. Refusing to provide the requested security is a criminal offence, subject to a maximum penalty of \$21,000.

Where the ATO demands a security that is of a higher value than the penalty, there is no incentive for the taxpayer to provide that security. This situation creates an incentive for the taxpayer to risk having to pay the penalty rather than provide the security requested. Furthermore, pursuing a Court penalty decision can take time, giving a business the opportunity to enter voluntary administration and phoenix. To address this issue, the Government has announced, as part of changes to superannuation guarantee,⁸ a change to the tax law to improve the effectiveness of security deposits. This amendment will apply to all applicable tax liabilities for consistent administration and collection.

Proposed reform

The Government intends to further strengthen the effectiveness of the security deposit power to target illegal phoenixing. Combatting phoenix operators protects the integrity of the tax system, provides a level playing field for business and protects employees.

Currently, any security bond requested by the ATO is unable to be recovered under third party debt collection provisions. These provisions⁹, known as the statutory garnishee power, are limited in that they apply to tax-related liabilities. As a security deposit is not presently a tax-related liability, the garnishee power cannot apply in relation to the security deposit demands. It is proposed that the ATO should be able to use the garnishee power to garnishee an amount from a third party to cover, in full or part, the amount of requested security.

As security deposits can be requested for either a current or an expected future tax liability, the use of garnishee powers from third parties will include amounts that are not yet due. This extension to the garnishee powers will be strictly limited to the circumstances of security deposits. This change will disrupt and deter businesses that are suspected of phoenix behaviour or are otherwise requested to provide security bonds by the ATO.

This proposal does not prevent a business from continuing to be able to seek a judicial review of any garnishee order.

8 The Hon Kelly O'Dwyer, *Turnbull Government backs workers on superannuation*, 29 August 2017.

9 Subdivision 260-A of the *Taxation Administration Act 1953*.

QUESTIONS

59. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
60. What are the benefits and risks of this approach?
61. Would improvements to the garnishee provisions adequately address the proposal to strengthen the effectiveness of the security deposit power?
62. Should the proposal be limited to businesses that have been identified as High Risk Phoenix Operators (see Part Two)?
63. Are there concerns or practical issues that would need to be addressed with expanding the garnishee power generally for *future* tax liabilities?
64. Are there any further concerns if this were achieved through amending the definition of 'tax-related liability' to include the amount of an anticipated *future* tax liability which is the subject of a security deposit demand?
65. Are there any issues with the existing garnishee processes that should be considered?
66. Should the Government consider additional measures to prevent circumvention of the provisions by transferring, disposing or encumbering assets where a request is issued?
67. Should the penalties for not complying with a security deposit request be increased to improve compliance?

PART TWO - DEALING WITH HIGHER RISK ENTITIES

Part Two of this paper sets out reforms which target the most egregious illegal phoenix operators who have adopted phoenixing into their business model, or who are active facilitators of illegal phoenix activity.

The Government has determined that in order to prevent phoenix activity from occurring, new preventative and early intervention measures are required.

However, it also acknowledges that it is important that any measures which have the potential to interfere with standard business practices are targeted as much as possible to entities which present the highest risk.

This Part sets out a mechanism for identifying those who present the highest risk of ongoing phoenix activity, and three specific reforms aimed at curbing their activities.

8. TARGETING HIGHER RISK ENTITIES

Current situation

Regulators largely rely on enforcement as a mechanism to deal with those who engage in illegal phoenixing as a business model. Where there are clear criminal or fraudulent actions, criminal charges may be available. These are expensive and time consuming for all parties. Criminal charges are also applied 'after the fact' when the phoenix activity has already been carried out.

How phoenix operators exploit the current law

There are presently no special compliance measures applied to entities or individuals who present a high risk of engaging in illegal phoenix activity.

The absence of effective preventative or early intervention measures which disrupt phoenix activity can make it difficult for regulators to prevent phoenix activity from occurring, even when the entities being targeted have previously been determined to be high risk.

Experienced phoenix operators will continue to cause loss to their employees, creditors, the revenue system and ultimately the Australian economy unless they are prevented from phoenixing further businesses.

For example taxpayers who are suspected of posing a higher level of risk to the tax system (as well as employees and other creditors), remain entitled to privileges of the self-assessment tax system, which they are able to exploit to their advantage.

The self-assessment tax system relies largely on voluntary compliance, where taxpayers are trusted to do the right thing until investigations establish otherwise. However, high risk phoenix operators exploit these privileges, and follow up compliance action may do little to deter them from repeating their behaviour.

Phoenix operators exploit the settings in regulatory regimes to their advantage. For example, under the current law, suspected phoenix operators may still:

- select their own liquidator, allowing them to engage a dishonest or conflicted liquidator;
- seek tax refunds while being overdue on forms that give rise to tax liabilities, for example by hastening lodgement of their Business Activity Statements to ensure they receive GST refunds while delaying lodgement of income tax returns which will result in a tax liability; and
- exploit the 21 day notice period under a Director Penalty Notice (which is intended to provide directors with a reasonable time to comply with their obligations such as remitting amounts withheld under the PAYGW system or payment of their employees' Superannuation Guarantee amounts) to dispose of or transfer assets.

Proposed reform – a two-tiered approach

A definitional approach to identifying those at highest risk of conducting illegal phoenixing faces the same challenges as defining “illegal phoenixing”: any definition is likely to be either too narrow, and thus ineffective, or too wide, and thus impact on legitimate businesses.

Additionally, some academic researchers have noted that it is difficult to provide a definition of high risk that is sufficiently inclusive of what might be described as the most egregious phoenix activity without also capturing some business rescue activities or other more accidental activities.¹⁰ Regulators and administrators note that those involved in phoenix activity exploit existing legislative provisions and are adept at circumventing black letter law, for example inserting unsuspecting “dummy” or “straw” directors into corporate structures and sometimes placing themselves outside of a recognised legal relationship with the businesses they control. There is a risk that a statutory definition would not adequately capture these individuals.

Rather than taking a definitional approach, the Government is proposing a mechanism for identifying and targeting the most egregious phoenix operators who have adopted phoenixing as a business model. This mechanism leverages off common phoenix behaviour.

This mechanism involves a two-step process:

1. designation as a “Higher Risk Entity” (HRE); and
2. being declared to be a “High Risk Phoenix Operator” (HRPO) by the Commissioner of Taxation, which would enliven the early intervention and prevention laws set out in this Part.

Designation as an HRE is a pre-requisite to being declared to be an HRPO.

Designation as a HRE will not automatically result in that individual being subjected to the exercise of the new powers proposed in this Part, nor any other powers which do not already apply.

Regardless of how a HRE is designated, the designation has no automatic or material impact on the activities of the individual or their associated entities.

¹⁰ Helen Anderson, Ann O’Connell, Ian Ramsay, Michelle Welsh and Jasper Hedges, ‘Phoenix Activity: Recommendations on Detection, Disruption and Enforcement’, The University of Melbourne, February 2017.

Step one – the objective test

Designation as an HRE would be based on certain objective threshold tests.

Individuals would automatically be designated HREs once the threshold had been met.

The Government is proposing to designate an individual an HRE where:

- They have previously been disqualified from managing a corporation; or
- They have been an officer of two companies which have entered liquidation in the previous seven years (or other appropriate period) and where:
 - there has been a failure to provide adequate books and records to an insolvency practitioner, or
 - an insolvency practitioner has lodged a report under section 533(1) of the Corporations Act in respect of the company, or
- They have been found to have committed a Phoenix Offence (if one is introduced (See section 1.3)) or the subject of promoter penalty sanctions; or
- They are an officer of an entity which has a poor regulatory compliance history that is consistent with suspected illegal phoenix activity, and they are provided with notice of their designation by the ATO (or another appropriate regulator, such as ASIC).
 - This may include involvement in past liquidations where claims have been made to the Fair Entitlements Guarantee Scheme, repeated failure to lodge required forms and returns in the lead up to liquidations, or repeated failure to keep records relating to the transfer of assets to related entities.

Step two – an administrative declaration

It is accepted that the pool of HREs may capture instances of honest business failure, and that those individuals should not be punished for their behaviour.

That is why a second step before the new powers can be imposed is proposed.

Once an individual is identified as an HRE, the Commissioner of Taxation would have the power to declare them to be an HRPO, and consequentially to apply the HRPO measures set out in this Part.

Decisions to apply these powers would be made on a case by case basis taking into account the surrounding circumstances, and rights of review continue to attach to the exercise of the powers.

Where an HRPO is an officer of a company, or has recently been an officer of the company, the Commissioner of Taxation will have the discretion to declare that company to also be an HRPO.

Notification and Safeguards

It is proposed that the Commissioner would be required to provide notification of their decision to declare an individual a HRPO, and that the declaration be subject to review.

However, on occasion it may be necessary for action to be taken swiftly by regulators against an entity to apply preventative measures (such as retaining tax refunds) where there is an imminent risk of phoenix activity occurring.

If an extensive merits review process were to attach to the designation as a HRPO, the review process could delay the application of these preventative measures. Such delay may undermine the effectiveness of these new measures in protecting employee entitlements, trade creditors and revenue.

One option could be for individuals designated as HRPOs to be entitled to request a statement of reasons for the designation, and given an opportunity to put forward contentions as to why the designation should be cancelled and supporting evidence of improved business practices. However this process would not suspend the use of the new preventative measures.

Cancellation of a determination could also occur unilaterally where the operator demonstrates a behavioural change.

QUESTIONS

68. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
69. What are the benefits and risks of this approach?
70. Are the safeguards for designating HRPO sufficient? Can you suggest any alternative safeguards that would still allow for swift preventative action to be taken to prevent phoenix activity from occurring?
71. What safeguards would be required to ensure that the measure is appropriately targeted?
72. Should the Commissioner of Taxation have a discretion to declare a company of which a HRPO is, or has recently been, an officer to also be a HRPO? Should this be extended to other individuals or entities which are associates of the HRPO?
73. Should "associate" be defined or determined administratively?

9. APPOINTING LIQUIDATORS ON A CAB RANK BASIS

The current situation

A well-functioning financial system should provide an efficient process for the external administration of insolvent or financially distressed companies which builds confidence, protects against misconduct, and promotes self-regulation and competition. Insolvency practitioners thus play a crucial role in the financial system.

A registered liquidator may be appointed as an external administrator of a company in the following capacities:

- as voluntary administrator of the company;
- as administrator of a deed of company arrangement entered into in relation to the company;

- as liquidator of the company (appointed by members or the court); or
- as provisional liquidator of the company.

Company directors initiate most of these appointments.

Before an appointment occurs, a registered liquidator must be approached to consent to act as external administrator of the company. In most instances, those approaches are made as a result of a referral by a lawyer, accountant or other pre-insolvency adviser.

In order to compete for work, a registered liquidator forms, and builds on, relationships with lawyers, accountants and other pre-insolvency advisers who might refer work to them.

How phoenix operators exploit the current law

Registered liquidators act in a fiduciary capacity and, in some cases they are officers of the court. They are required to maintain professionalism, independence, impartiality, honesty and ethics in the performance of their functions and duties.

However, as phoenixing becomes more sophisticated, the Phoenix Taskforce has identified cases where facilitators will cultivate a relationship with an individual registered liquidator who will facilitate their client's interests to the detriment of creditors.

An incentive exists for these registered liquidators not to 'bite the hand that feeds them', which can undermine their independence or lead to a conflict of interest. The current referral model potentially facilitates and provides opportunities for a dishonest registered liquidator to exercise "wilful blindness" and act in other ways which facilitate misconduct, including illegal phoenix activity.

In these circumstances, referral relationships between pre-insolvency advisers and a dishonest registered liquidator can result in illegal phoenix activity occurring and not being adequately investigated. Even the actions of a single individual can undermine market confidence.

These circumstances provide an unfair advantage over other registered liquidators competing in the market for insolvency services who strive to ensure they meet their statutory and fiduciary obligations and properly perform their duties and functions.

Appropriate measures to address actual or perceived concerns regarding independence arising from the current referral system for the appointment of external administrators are central to combatting illegal phoenix activity.

A cab rank model has been recommended as one method of addressing issues of registered liquidator independence, facilitator referrals and director misconduct that underpin some illegal phoenix activity by:

- minimising the risk that the registered liquidator is subject to any influence that might lead them to not bring an impartial mind to the conduct of the external administration;
- reducing the ability for untrustworthy advisers to collude with registered liquidators to operate to defeat the interests of creditors; and
- increasing the prospect of illegal phoenix activity being detected and investigated.

Proposed reform – what is a cab rank system?

The idea of a cab rank system is to provide a director with access to an independent registered liquidator who can provide advice on the options available to the director to deal with the company's financial position.

Under a cab rank system, a registered liquidator would be chosen from a panel on a “next-cab-off-the-rank” basis in certain circumstances.

Panels would be regionally based, and panel liquidators would retain the right to refuse an appointment, for example because of a conflict of interest, time constraints or if they considered that they lacked the requisite experience to properly carry out the administration or liquidation.

When dealing with instances of low or no-asset companies, the activities of panel-appointed liquidators would need to be funded, for example via a component of the industry levy on corporations, to ensure that matters were investigated and properly reported to both the creditors and to ASIC.

The funding would finance registered liquidators’ basic investigations and reporting, and would replace the current widespread practice of directors indemnifying registered liquidators for their costs.

Most external administration appointments do not result from a referral where improper pre-insolvency advice has been provided and where illegal phoenix activity is suspected. It is thus important that any mechanism aimed at curbing illegal phoenixing is not detrimental to the overwhelming majority of registered liquidators who have done the right thing.

Option 1 – High Risk Phoenix Operators

Under this proposal, the cab rank rule would apply only to a company where an officer of the company is, or was during a prescribed period prior to the appointment of an external administrator, an HRPO (section 2).

QUESTIONS

74. On a scale of one to ten, where one is ‘ineffective’ and ten is ‘highly effective’, please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
75. Are there alternate measures that would be more effective? If so, please provide an outline of what you think would work.
76. Currently, it is intended that the cab rank be restricted to circumstances where an HRPO is or has recently been an officer of the company.
77. Should a cab rank apply to all external administration appointments?

QUESTIONS (CONTINUED)

78. Should it be applied more widely, but be limited to specified types of external administration appointments where certain criteria are met? For example:

- whether it was a director initiated creditors' voluntary liquidation and/or the appointment of a liquidator following a voluntary administration
- industry sector
- whether pre-insolvency advice was received
- prescribed criteria on the company's financial affairs
- when there has been a recent transfer identified for some or all the companies assets
- where there has been a change of directors within a prescribed period.

If the cab rank applies only to those companies where specified criteria are met what should those criteria be? Please specify your reasons.

79. Who should administer the cab rank and how should it be administered? Please explain your reasoning.

80. How do you think such a system should be funded?

Option 2 – a Government Liquidator

Another option is to establish a "government liquidator" to conduct a streamlined external administration of small-to-medium size enterprises with the option to appoint a private registered liquidator if circumstances warranted it. A similar system currently operates in personal insolvency.

QUESTIONS

81. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.

82. Should consideration be given to establishing a government liquidator to conduct small-to-medium external administrations? Please provide your reasons.

83. What are the benefits and risks of this approach?

84. If a government liquidator is created, what external administrations should they conduct? Please provide your reasons.

85. How do you believe a government liquidator should be funded?

10. REMOVING THE 21 DAY WAITING PERIOD FOR A DPN

Current situation

Currently, where a company has not met certain tax obligations, the company's directors are personally liable to pay the ATO a penalty equivalent to the unpaid tax liability. Currently, this power is only applicable to PAYGW and SGC (but could be extended to include GST, see section 6).

To recover the penalty, the ATO must issue a DPN.¹¹ Once the DPN is issued, the directors have 21 days to take corrective action. There are three options available to the directors in this situation: ensure their company pays the outstanding amounts, pay the penalty specified in the notice, or ensure their company enters voluntary administration or is placed into liquidation. This third option is not available to the directors if the company's PAYGW or SGC liability is not reported to the ATO within 3 months of the due day.

If the directors take no action within the 21 days, then the ATO may commence proceedings to compel the directors to pay the penalty.

The use of the director penalty is a powerful tool in the collection of outstanding tax obligations, however some directors have found ways to exploit certain aspects of the DPN provisions in order to escape personal liability. To help counter this behaviour, the Government announced on 29 August 2017 proposals to strengthen the DPN regime as part of a package of measures to strengthen employer compliance with superannuation guarantee obligations. The Government has further proposals to strengthen the DPN regime as part of the phoenixing package, which are set out below.

How phoenix operators exploit the current law

Directors of high risk phoenix businesses having received a DPN are known to dispose of their personal assets before the expiration of the 21 day notice period, preventing the ATO from acquiring those assets to discharge the penalty. For such directors, the DPN is effectively a signal to take steps to frustrate the ATO's attempts to recover unpaid PAYGW and SGC.

Proposed reform

By removing the 21 day period for those directors identified as HRPOs, the ATO will be able to commence recovery of the penalty as soon as the DPN is issued.

Directors who are not designated as HRPOs will still be entitled to 21 days' notice from the date a DPN is given.

This proposal is designed to act as a behavioural and financial disincentive for phoenix activity. It removes a time period in which HRPOs can dissipate their personal assets. It will contribute to the collection of outstanding superannuation payments owing to employees of companies that have been subjected to phoenixing behaviour, as well as the collection of PAYGW and GST (if the proposal at section 6 above progresses).

11 DPN provisions are located in Division 269 of Schedule 1 to the *Taxation Administration Act 1953*.

QUESTIONS

86. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
87. Should the 21 day notice period be removed where a director has been designated as a HRPO?
88. What are the benefits and risks of this approach?
89. Should further safeguards attach to DPNs issued to HRPOs in addition to the existing legal rights and safeguards that currently apply to DPNs?
90. Are there alternative approaches to stop a designated HRPO from disposing of their personal assets once they are aware they are required to pay a director penalty?

11. PROVIDING THE ATO WITH THE POWER TO RETAIN REFUNDS

The current situation

The ATO can only retain refunds in specific circumstances:

1. Any refund where the business has not provided a notification under the Business Activity Statement (BAS) provisions or Petroleum Resource Rent Tax (PRRT) provisions.¹²
2. Any refund where information is being verified by the ATO, where it would be reasonable to do so and relates to the amount that the ATO would otherwise have to refund. This power applies equally to BAS notifications and income tax lodgements.¹³
3. Any refund where the ATO reasonably believes the business has not notified the ATO under the single touch payroll reporting provisions (where they apply).¹⁴
4. Refunds of a running balance account (RBA) surplus only (not income tax refunds) where financial institution account details have not been provided.¹⁵

How phoenix operators exploit the current law

Phoenix operators are known to arrange the timing of their lodgements to ensure that they receive their refunds as soon as possible, but delay or avoid lodgement of any returns which are expected to result in a liability.

12 Section 8AAZLG of the *Taxation Administration Act 1953*.

13 Section 8AAZLGA of the *Taxation Administration Act 1953*.

14 Section 8AAZLGB of the *Taxation Administration Act 1953*.

15 Subsection 8AAZLH(4) of the *Taxation Administration Act 1953*.

Where a business has lodged a BAS resulting in a refund/RBA surplus, but has failed to lodge their overdue income tax return, the ATO is currently obligated to refund the credit even where that taxpayer is suspected of seeking to engage in phoenix activity. Due to the lodgement cycles, there can also be many months gap between the due date for lodgement of notifications that may result in a refund (for example a BAS) and notifications that may result in a liability (for example an income tax return). Phoenix operators have been known to exploit this timing difference by stripping assets from the entity that they intend to be left with the debts.

Administrative penalties for late lodgement of returns do apply¹⁶, however these penalties are for relatively small amounts when compared to the cost of illegal phoenix activity and are unlikely to deter phoenix operators who may also end up avoiding payment of the penalties where the company is stripped of its assets and liquidated.

Proposed reform

Where a person has been designated as a HRPO, it is proposed that the law be expanded to allow the Commissioner to retain a refund¹⁷ that otherwise would have been refunded to the HRPO in circumstances where the HRPO has an overdue lodgement or notification capable of affecting a tax liability. HRPOs will therefore be required to lodge all outstanding notifications that are capable of affecting their tax liability before a refund is issued. This will help to disrupt the phoenix business model and protect tax revenue, while still ensuring legitimate businesses can operate in a commercial setting.

Note that if the ATO's power to retain refunds is expanded in relation to HRPOs who have notifications outstanding, interest on the refund would not commence until the 14th day after any such notification were given by the HRPO.¹⁸

QUESTIONS

91. On a scale of one to ten, where one is 'ineffective' and ten is 'highly effective', please rate how well you think this measure will operate to deter and disrupt illegal phoenix activity.
92. Should the ATO's power to retain refunds be broadened in respect of HRPOs who have failed to provide other notifications/lodgements capable of affecting their tax liability?
93. What are the benefits and risks of this approach?
94. Should this proposed power be broadened further where notifications are not yet due but will become due in the next reporting cycle? For example where lodgement of an income tax return by the HRPO is not due for some months but is expected to result in a significant liability, should the ATO be able to retain a refund presently owed?

16 Failure to Lodge penalty is calculated at the rate of one penalty unit (currently \$210) for each period of 28 days that the return is overdue, up to a maximum of five penalty units (\$1050). Higher penalty amounts apply for larger entities.

17 An RBA surplus or non-RBA credit.

18 *Taxation (Interest on Overpayments and Early Payments) Act 1983*.