



**Australian Government**

# Action against fraudulent phoenix activity

Proposals Paper

November 2009

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ISBN 978-0-642-74528-6

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## CONSULTATION PROCESS

### Request for feedback and comments

The Government is seeking your feedback and comments on the options outlined in this proposals paper, particularly any information about the suggested approaches to target fraudulent phoenix activity, including the impacts, costs and benefits. We also seek your advice on any potential unexpected consequences of the proposed changes.

The information will inform the Government's proposed approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

### Closing date for submissions: 15 January 2010

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## FOREWORD



I am pleased to release this discussion paper on proposals to take action against fraudulent phoenix activity. Similar to the mythical creature from which it takes its name, phoenix activity in its basic form involves the winding up of a company and the subsequent continuation of that business in a new 'risen' company.

This activity is undertaken for gain through the evasion of tax and employee entitlements. The Australian Taxation Office (ATO) estimates that the current stock of suspected phoenix cases it is monitoring poses an unacceptable risk to revenue in the order of \$600 million.

During an economic downturn, the financial pressures faced by businesses are significant. While the Government has demonstrated its commitment to helping those businesses suffering from the global recession, it is also committed to ensuring that businesses do not structure arrangements in a way that dishonestly maximises personal wealth or creates an unfair competitive advantage.

Fraudulent phoenix activity is an abuse of the corporate form and the privilege of limited liability. At a time of greater uncertainty for workers, the avoidance of employee entitlements such as superannuation and long service leave is particularly unacceptable.

This discussion paper provides an overview of the problems that fraudulent phoenix activities cause in the collection of tax revenue and other employee entitlements. It then presents a range of proposals for the taxation and corporations laws to address them while at the same time not impacting on legitimate business failures. To highlight the nature of fraudulent phoenix activity in Australia, it includes a number of case studies based on the experiences of the ATO.

Consultation plays a valuable role in developing policy responses to changes in the tax law and I look forward to receiving the views of the community on these important reforms.

### SIGNED

**Assistant Treasurer**  
Senator Nick Sherry

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## SUMMARY OF OPTIONS TO ADDRESS FRAUDULENT PHOENIX ACTIVITY

### Options in the taxation law

Option	Brief description
Amendment to the director penalty regime	Remove the ability of directors engaged in fraudulent phoenix activity to avoid personal liability for Pay As You Go (Withholding) (PAYG(W)) liabilities by placing the company into voluntary administration or liquidating the company.
Expansion of the director penalty regime	Expand the director penalty regime to apply to superannuation guarantee (SG) liabilities and other taxation liabilities such as indirect tax liabilities and a company's own income tax liability.
Amendment to the promoter penalty regime	Ensure that the promoter penalty regime is able to target those individuals promoting fraudulent phoenix activity.
Expansion of anti-avoidance provisions	Ensure that there are anti-avoidance provisions in the taxation law (either through an expansion of the existing general anti-avoidance rule (GAAR) or through the creation of a specific provision) to effectively negate any taxation benefit derived from fraudulent phoenix activity.
Reinstate the 'failure to remit' offence	Reintroduce a provision that would make it an offence for an entity not to remit the required PAYG(W) amounts.
Denial of PAYG(W) credits	Deny directors of companies (and potentially close relatives) from being able to access PAYG(W) credits in relation to their own income where amounts withheld have not been remitted (to the ATO) by the company.
Introduce an offence for claiming non-remitted PAYG(W) credits	Make it an offence for directors to claim credits in relation to their own income for PAYG(W) amounts that have not been remitted by the company of which they are a director.
Amendment of taxation bond provision	Provide the Commissioner of Taxation with the discretion to require a company to provide an appropriate bond (supported by sufficient penalties) where it is reasonable to expect that the company would be unable to meet its tax obligations and/or engage in fraudulent phoenix activity.

## Options in the corporations law

Option	Brief description
Expand the scope for disqualification of directors	Give a Court or the Australian Securities and Investment Commission (ASIC) a discretion to disqualify a person from being a director if the relevant company has been wound up and the conduct of the person, as a director of that company, makes them unfit to be concerned in the management of a company.
Restrict the use of a similar name or trading style by successor company	Make directors personally liable for the debts of a liquidated company in circumstances where a 'new' company adopts the same or similar name as its previous incarnation.
Adopt the doctrine of inadequate capitalisation	Allow the corporate veil to be lifted where a company sets up a subsidiary with insufficient capital to meet the debts that could reasonably be expected to arise.



# 1. OVERVIEW

## 1.1 WHAT IS FRAUDULENT PHOENIX ACTIVITY?

Fraudulent phoenix activity involves the evasion of tax and other liabilities such as employee entitlements through the deliberate, systematic and sometimes cyclic liquidation of related corporate trading entities. The following section provides further details on what such activity involves.

### 1.1.1 Distinction between a legitimate use of the corporate form and fraudulent phoenix activity

Corporate law in Australia has traditionally reinforced the values of entrepreneurship and commercial risk-taking, which are seen to be fundamental to wealth creation and a well-functioning market. Limited liability for companies generally shields directors and shareholders from costs associated with the failure of the company. A genuine business failure where the business has been responsibly managed and subsequently continues using another corporate entity is a legitimate use of the corporate form.

#### Case study: legitimate use of the corporate form

Michael is a director of XYZ Pty Ltd and becomes aware that the company is no longer in a position to pay its debts. After promptly taking legal advice on his options Michael decides to place the company into liquidation. Michael arranges to purchase some of the assets from the liquidator at market price. The liquidator pays the creditors the funds received from the sale of these and other assets but there are insufficient funds for the debts to be paid in full. Michael subsequently sets up a similar business using another company of which he is also a director.

This legitimate use of the corporate form should be contrasted with dishonest practices that abuse the corporate form and the privilege of limited liability as a means of generating personal wealth or an unfair competitive advantage. The abuse of the corporate form to avoid payment of taxation liabilities, described further below, has significant implications for revenue. In addition the non payment of employee entitlements is also often a feature of such activity.

Defining precisely what constitutes fraudulent phoenix activity is inherently difficult. This was noted by the Parliamentary Joint Committee on Corporations and Financial Services in its report on corporate insolvency laws in 2004.<sup>1</sup> However, underlying the distinction between illegitimate, or fraudulent, phoenix activity and a legitimate use of the corporate form, is the intention for which the activity is undertaken. Relevantly, ASIC draws a

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<sup>1</sup> Parliamentary Joint Committee Report on Corporations and Financial Services 2004, Corporate Insolvency Laws: A Stocktake, The Commonwealth of Australia, Canberra, par 8.2.

distinction between businesses that get into a position of doubtful solvency or actual insolvency as a result of poor business practices (for instance, poor record keeping or poor cash management practices) and those operators who deliberately structure their operations in order to engage in phoenix activity to avoid meeting obligations. The contrast between fraudulent phoenix activity and a legitimate use of the corporate form is also captured by the Australian Taxation Office (ATO) which defines phoenix activity to be:

‘the evasion of tax through the *deliberate, systematic* and sometimes cyclic liquidation of related corporate trading entities’ (emphasis added).

### 1.1.2 Typical structure of fraudulent phoenix arrangements

In its most basic form fraudulent phoenix activity involves one corporate entity carrying on a business, accumulating debts without any intention of repaying those debts (for the purpose of wealth creation or to boost the cash flow of the business) and liquidating to avoid repayment of the debt. The business then continues in another corporate entity, controlled by the same person or group of individuals.

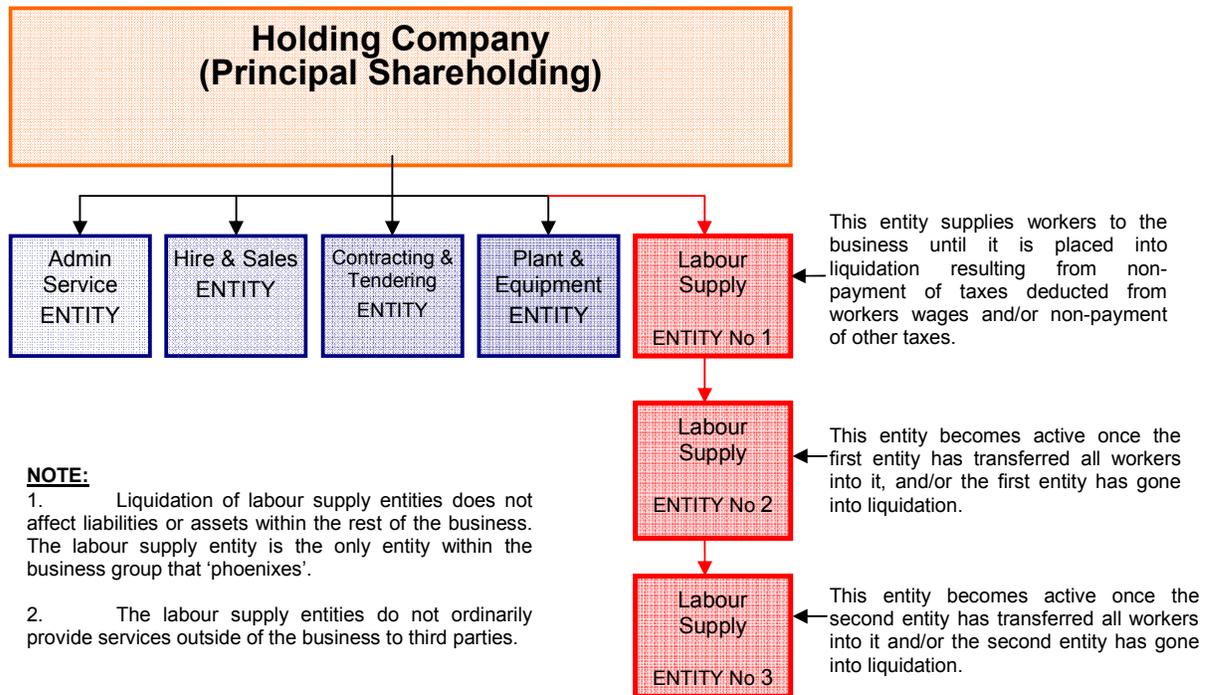
Fraudulent phoenix arrangements are, however, often more sophisticated. In the ATO’s experience, a typical fraudulent phoenix arrangement would be structured as follows:

- a closely held private group is set up, consisting of several entities one of which has the role of hiring the labour force for the business;
- the labour hire entity will usually have a single director who is not the ultimate ‘controller’ of the group;
- the labour hire entity has few, if any, assets and little share capital;
- the labour hire entity fails to meet its liabilities and is placed into administration or liquidation by the ATO;
- a new labour hire entity is set up and the labour moved across to work under this new entity; and
- the process is repeated, with little disruption to the day-to-day operation of the overall business and the financial benefits from the unpaid liabilities are shared amongst the wider group.

#### **Case study: structuring of fraudulent phoenix arrangements**

A labour hire business with negligible assets and turnover of \$30m per annum fragmented its operations across 53 related companies, lodged accurate business activity statements (BAS) for all companies, but failed to remit the required amounts under the PAYG(W) system. The single company director then liquidated every one of these companies within a week, moved his workforce of 2,700 into 8 new entities and continued trading. He has since fled Australia. Over \$8m in taxes remain unpaid. This labour hire business is still trading and failing to comply with its obligations.

The typical structure of a fraudulent phoenix arrangement is depicted in the diagram below:



## 1.2 PAST CONSIDERATION OF PHOENIX ISSUES

The problem of fraudulent phoenix activity in Australia, both generally and in specific industries, has been considered on a number of occasions by a range of bodies. These reviews have confirmed that fraudulent phoenix behaviour poses a serious problem. The most significant of these previous reviews are noted below.

### Australian Securities Commission 1996 report

In 1996, the then Australian Securities Commission (now ASIC) published its investigation into the problem of fraudulent phoenix activity in Australia. The report estimated annual losses to the Australian economy due to phoenix activities as between \$670 million to \$1.3 billion.

### Cole Royal Commission

In 2003, the prevalence and problems of fraudulent phoenix activity in the building and construction industry were considered by the Royal Commission into the Building and Construction Industry (the Cole Royal Commission). The Cole Royal Commission heard evidence from a range of organisations, noting that there was evidence of significant

phoenix activity in the industry, often associated with tax avoidance and the avoidance or underpayment of workers' compensation premiums.

### **Joint Committee Report**

In its 2004 stocktake of corporate insolvency laws, the Parliamentary Joint Committee on Corporations and Financial Services received a number of submissions on instances of fraudulent phoenix activity in the Australian economy, noting that 'almost all regarded the problem as a serious one requiring the attention of the legislature and were supportive of strengthening measures against phoenix companies'.<sup>2</sup>

These reviews resulted in some administrative, compliance and legislative changes to address fraudulent phoenix activity. Some of these measures are highlighted below in Chapter 3.

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2 Parliamentary Joint Committee report on Corporations and Financial Services report 2004, par 8.35.

## 2. THE IMPACT OF FRAUDULENT PHOENIX ACTIVITY ON TAX LIABILITIES

Tax liabilities are often left unpaid after the liquidation of a fraudulent phoenix entity. This may reflect a range of factors, including the relative benefit that a phoenix operator can obtain from non-payment of the business' taxation liabilities and the fact that such an operator need not be concerned with maintaining a commercial relationship with the ATO.

While the cost of fraudulent phoenix activity is difficult to measure precisely it is undoubtedly significant. The ATO estimates that the current stock of suspected phoenix cases it is monitoring poses a risk to the revenue of around \$600 million. Moreover, as the 1996 report of the Australian Securities Commission indicates (see paragraph 1.2), it is clear that fraudulent phoenix activity imposes a significant cost to the broader Australian economy.

This Chapter provides a brief overview of the tax and revenue problems caused by fraudulent phoenix activity and recent trends that have been observed by the ATO.

### 2.1 TYPE OF TAXES AND LIABILITIES AFFECTED BY FRAUDULENT PHOENIX ACTIVITY

In the past the biggest impact on the revenue has come from phoenix companies which fail to remit amounts withheld under the PAYG(W) system. These funds relate to the tax liability of a particular employee and it is as if the employer holds these funds 'on trust'. Such funds should never become part of the cash-flow of a business.

While the benefit from the non-remission of PAYG(W) is often derived in relation to the salary and wages of the employees of the company (particularly a labour supply company), fraudulent phoenix activity also involves directors claiming access to PAYG(W) credits in their own personal income tax returns where their company has not remitted, and will never remit, such moneys to the ATO. Such actions seek to take advantage of provisions in the taxation law that allow a taxpayer to access credits for amounts withheld, irrespective of whether or not those amounts have been remitted.<sup>3</sup>

#### **Case study: claiming PAYG(W) credits by directors for non-remitted amounts**

A director maintained wages records (gross/tax/net amounts) for a company. At year end the directors issued themselves a payment summary which resulted in a refund of tax withheld, once they lodged their personal income tax returns. Meanwhile, their company did not remit the tax withheld from their wage and 'phoenixed' to avoid liability once it received a director penalty notice from the ATO. This happened over consecutive years.

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<sup>3</sup> See section 18-15 of Schedule 1 to the TAA 1953. Permitting credits to individuals even when amounts are not remitted ensures that an individual is not effectively taxed twice, once where amounts are withheld from their wages and again when the Commissioner seeks to collect unpaid amounts that have not been received.

Fraudulent phoenix operators also benefit from the non-payment of other liabilities imposed by the taxation law. This includes SG payments. The non-payment of SG is of particular concern as, unlike other liabilities imposed under Australia's taxation laws, it will result in a direct loss to the individual employee.

Fraudulent phoenix activity may, as the case study demonstrates below, also involve the manipulation of GST input tax credits (ITCs).

#### **Case study: fraudulent phoenix activity and GST**

Company A sells its 'assets' to related company B, with the sale price including the GST. These 'assets' may be equipment and the value may be fair, inflated or understated, depending on the outcome being sought. Company B claims a GST ITC from the ATO. A short while later Company A proceeds into voluntary liquidation, and does not remit the GST included in the sale price of the assets. Company B continues for a short time, then repeats this process via (newly incorporated) Company C.

## **2.2 INDUSTRIES**

The particular prevalence of fraudulent phoenix activity in the building and construction industry was highlighted by the Cole Royal Commission. However, fraudulent phoenix activity is not limited to that sector— it has spread to other industries where labour costs are high, such as the labour hire, employment, security, road transport and the cleaning industry.

Fraudulent phoenix activity is also being observed by the ATO within the property development sector. Property developers claim GST ITCs upfront on acquisitions made from related entities, while the entity with the GST liability subsequently liquidates and the liability goes unpaid.

## **2.3 TYPES OF BUSINESSES**

Historically, fraudulent phoenix activity has been most prevalent with small business, that is, those businesses with a turnover below or around \$2 million. However in recent years the ATO has seen fraudulent phoenix activity being undertaken by much larger businesses and by individuals who already have significant levels of wealth.

Concern over the spread of fraudulent phoenix activity to a wider range of businesses and across more industries is also heightened by the apparent increase in the numbers of individuals promoting the benefits of fraudulent phoenix activity. This was noted by the Joint Committee of Public Accounts and Audit in its report on tax administration tabled on 26 June 2008.<sup>4</sup>

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<sup>4</sup> Joint Committee of Public Accounts and Audit July 2008, Report 410 into Tax Administration, Canberra, par 2.48.

### 3. EXISTING MEASURES TO DETER FRAUDULENT PHOENIX ACTIVITIES AND THEIR LIMITATIONS

A number of existing legislative and administrative mechanisms can be and are used to address aspects of fraudulent phoenix activity. This Chapter provides an overview of:

- measures in the taxation law, including their limitations; and
- measures in Australia's corporate law regime (including those sanctions contained in the *Corporations Act 2001* (Corporations Act) or programs that are otherwise administered by ASIC).

It is clear that these existing mechanisms do not provide a sufficient disincentive to prevent fraudulent phoenix activity.

#### 3.1 TAX LAW MECHANISMS AND THEIR LIMITATIONS

There are a number of potential mechanisms in the taxation law that could be used to curb fraudulent phoenix activity. However, there are a number of limitations with these existing mechanisms that prevent them from being used effectively for this purpose. For instance, some are focused narrowly on income tax and, in their present form, they cannot directly address other liabilities such as SG amounts or GST.

Moreover, as noted above, the existing mechanisms provide little incentive not to phoenix, and remedial action is conducted on a case by case basis, well after the damage has been done.

##### 3.1.1 The director penalty regime

To compensate for the removal of the Commissioner of Taxation's statutory priority in a winding up for the collection of certain outstanding taxation liabilities,<sup>5</sup> two new collection regimes were included in the *Income Tax Assessment Act 1936* (ITAA 1936). These included a regime that permitted the Commissioner to make an estimate of unpaid PAYG(W) liabilities and to commence recovery action on the basis of that estimate<sup>6</sup> and the director penalty regime<sup>7</sup>.

The director penalty regime places an obligation on a director of a company, before the due date for paying a PAYG(W) amount to the ATO, to cause the company to do one of the following four things:

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5 This statutory priority effectively lifted the Commissioner's claim, in a winding up process, to outstanding pay-as-you-earn (PAYE) liabilities ahead of some secured creditors and employee's claims for wages and other entitlements as well as unsecured creditors. It was removed in part on the basis that the Commissioner's priority was seen as unfair to employees and other unsecured creditors who had to wait until any outstanding PAYE liabilities were paid before their claims could be considered.

6 See Division 8 of Part VI of the ITAA 36.

7 See Division 9 of Part VI of the ITAA 36.

- to comply with its obligations in relation to paying the PAYG(W) amounts to the Commissioner;
- to enter into a payment agreement with the Commissioner in relation to the amounts;
- to appoint an administrator of the company; or
- to wind up the company.<sup>8</sup>

If the company does none of these things, the director is liable to pay a penalty equal to the unremitted amounts.<sup>9</sup>

However, before collecting the penalty, the Commissioner is obliged to give the director 14 days notice.<sup>10</sup> The director can avoid the pending liability by causing the company to take one of the four actions listed above.<sup>11</sup> In the ATO's experience phoenix operators usually avail themselves of the latter two options upon receiving a director penalty notice.

Unlike the Commissioner's former statutory priority, the director penalty regime does not rely on a company being placed into some form of external administration before the Commissioner can collect unremitted amounts. Instead, by making directors personally liable for such amounts it encourages those in control of the company to confront solvency problems earlier and, accordingly, prevent the mounting up of debts.

## Limitations

There are a number of limitations on the current director penalty regime that have prevented the ATO from using it effectively to curb fraudulent phoenix activity. Notably:

- issuing director penalty notices to crystallise a director's debt is highly resource intensive and means that director penalty notices are issued to only a small percentage of directors who would otherwise be liable as a result of the regime. Moreover, the director penalty notice is often not issued until some 6–12 months after a penalty was first incurred<sup>12</sup>;
- fraudulent phoenix activity often involves the non-reporting of PAYG(W) obligations. As a consequence, it is only when employees claim PAYG(W) credits at the end of the financial year that it becomes apparent that such amounts have not been reported and remitted. By then, many months of PAYG(W) liabilities have been generated; and
- as the regime focuses only on PAYG(W) liabilities, it does not provide any disincentive for fraudulent phoenix operators to accrue other liabilities, such as SG payments.

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8 Section 222AOB of the ITAA 36.

9 Section 222 AOC of the ITAA36.

10 Section 222AOE of the ITAA36.

11 Section 222AOG of the ITAA36.

12 There are presently 710,843 companies registered for PAYG (W) obligations, each of those falls within the scope of the present director penalty regime. In 2007 and 2008 financial years, the total number of director penalty notices issued was, respectively, 3198 and 2965.

### 3.1.2 The promoter penalty regime

As noted above, the promotion of fraudulent phoenix activity is an increasing problem.

The promoter penalty regime<sup>13</sup> was introduced in 2006 to deter the promotion of tax avoidance and evasion schemes. It allows the Commissioner to ask the Court to impose a penalty against an individual who has received consideration for marketing or otherwise encouraging the growth of a tax exploitation scheme.

#### Limitations

For there to be a tax exploitation scheme, a benefit must be derived where the tax liability becomes less than it would have been but for the scheme. Fraudulent phoenix activity would not be considered to be a tax exploitation scheme because it doesn't change the amount of a tax liability, but rather ensures that the liability will never be paid.

Similarly, because phoenix activity does not reduce a company's liability to the SG surcharge, promoter penalties in their current form would not directly address unpaid superannuation contributions.

### 3.1.3 Anti-avoidance provisions

The taxation law currently contains a number of anti-avoidance provisions, most notably the GAAR in Part IVA of the ITAA 1936. The GAAR provides a measure of last resort (where other legislative mechanisms have failed) as a means of countering tax avoidance. For the GAAR to apply, a tax benefit must be derived from a scheme with the sole or dominant purpose of obtaining a tax benefit. If these conditions are satisfied the Commissioner can then make a determination to cancel the benefit.

#### Limitations

There are three clear limitations that prevent the GAAR from applying to fraudulent phoenix activity. First, the definition of 'tax benefit' is currently limited to amounts not being included as assessable income, or a deduction, capital loss or foreign tax credit being allowed. Like the promoter penalty regime, this does not capture the benefit derived from fraudulent phoenix activity.

Secondly, the GAAR only provides the Commissioner with a remedy against the entity that has avoided the liability. In the fraudulent phoenix context this would be the phoenixed company and not the individual or 'risen' company that acquires the benefit of the activity.

Thirdly, the GAAR currently has a limited application and does not cover other liabilities like the SG.<sup>14</sup>

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<sup>13</sup> See Division 290 of Schedule 1 to the TAA 1953.

<sup>14</sup> Though there are general anti-avoidance rules that do apply to other liabilities such as GST — see Division 165 of the *A New Tax System (Goods and Services Tax) Act 1999*.

### 3.1.4 Denying directors credits for unpaid PAYG(W)

As noted above, an individual who has had amounts withheld through the PAYG(W) system is entitled to a credit for those amounts, irrespective of whether they have been remitted. Indeed the usual practice of the Commissioner is to allow a taxpayer credit upon assessment for amounts withheld substantiated by a payment summary completed by the payer or a statutory declaration in lieu.

While a credit cannot be denied for non-remitted amounts, the Commissioner does deny credits on the basis that an amount was not withheld in the first place. In the context of fraudulent phoenix activity the Commissioner's current practice is to deny the credit where the payee is a director of the paying entity and the Commissioner has evidence to support the view that no actual moneys were withheld.

### Limitations

Relying on the basis that no amount was withheld requires the Commissioner to obtain evidence that in fact amounts were not withheld. This is difficult, particularly where the Commissioner is presented with a completed payment summary that suggests otherwise. This can be compared to the non-remittal of amounts, which is readily apparent from the non-payment to the Commissioner. Denying credits in these instances is also reliant on the ATO's ability to effectively identify such behaviour which can be hampered by fraudulent phoenix directors intentionally claiming amounts below the thresholds at which the ATO is known to conduct its detection activities.

These limitations are exacerbated by the fact that there is no apparent offence provision in the taxation law, the *Crimes Act 1914* or the *Criminal Code Act 1995* that would act as a sufficient disincentive to entities claiming credits in this way. Although the *Criminal Code Act 1995* and *Crimes Act 1914* do contain offence provisions for 'defrauding' the revenue, the ATO has attempted unsuccessfully to treat as fraud the failure to pay tax instalment deductions to the Commissioner.<sup>15</sup> Furthermore, fraud investigations typically involve the resources of the Australian Federal Police (AFP) and the Commonwealth Director of Public Prosecutions (CDPP) which can be problematic due to competing priorities for the same resources. Notably, in the ATO's experience phoenix prosecutions, based as they are on fraud, are usually highly resource intensive, very costly and may take some years to be finalised.

### 3.1.5 Requiring the provision of a bond

The ITAA 1936 currently includes a provision that allows the Commissioner to seek a bond from a person who the Commissioner considers is likely to carry on a business for only a short period of time.<sup>16</sup> The bond or deposit acts as security for tax on income that is anticipated to be generated by that business. The failure to provide the bond is an offence and a person can be subject to a penalty of \$2, 200.

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<sup>15</sup> See for instance — *R v Ianelli* 2003 NSWCCA 1.

<sup>16</sup> Section 213 of the ITAA 36.

## Limitations

The limited penalty attached to the non-provision of the bond, along with the fact that the bond can only be required in relation to the payment of income tax, significantly limits its use as a mechanism for addressing fraudulent phoenix activity.

### 3.2 MECHANISMS THAT FORM PART OF AUSTRALIA'S CORPORATE LAW REGIME

While Australia's corporate law regime does not define and penalise fraudulent phoenix activity as such, directors involved in fraudulent phoenix activity may find themselves in breach of certain duties or provisions in the Corporations Act and subject to offence or civil recovery provisions. Notably, these include:

- the duty of a director not to allow a company to incur debts when the company is insolvent<sup>17</sup>;
- a provision rendering a person liable to compensate for loss of employee entitlements where an arrangement or transaction is entered into for the purpose of avoiding the payment of those entitlements<sup>18</sup>; and
- a provision for disqualifying directors who have been involved in multiple corporate failures.<sup>19</sup>

In addition to these sanctions, ASIC also administers a range of programs that help it to address the problem of fraudulent phoenix activity. These include:

- the Assetless Administration Fund, which funds preliminary investigations by expert liquidators of companies, selected by ASIC, that have been left insolvent with little or no assets;
- the National Insolvent Trading Program which aims to have company directors actively manage their company's financial position and act early or seek early advice when financial difficulties arise; and
- the Liquidator Assistance Program which aims to ensure directors of companies in external administration comply with their obligations to provide information about companies they manage.

Further information on these sanctions can be found at Appendix A.

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17 See section 588G of the Corporations Act.

18 See Part 5.8A of the Corporations Act.

19 See section 206F of the Corporations Act.

## **4. OPTIONS TO ADDRESS FRAUDULENT PHOENIX ACTIVITY**

### **4.1 STRATEGIC CONTEXT OF VARIOUS APPROACHES**

The increase of fraudulent phoenix activity in recent years is an indication that the current legislative and administrative regimes do not provide a big enough disincentive to engage in such activity.

In considering measures to address the limitations of existing deterrents in the tax law, it is important to be clear about the precise goal of future amendments and the factors that must be taken into account when weighing the relative merits of each proposal.

First, any option must be appropriately targeted to balance the inherent difficulty of identifying fraudulent phoenix activity with the importance of ensuring that innocent directors and companies are not captured inadvertently by any new regime. This is particularly the case in the current economic climate where entrepreneurship and responsible risk taking need to be encouraged. Equally, however, the pressures placed on the revenue caused by the current environment together with the ongoing public interest in ensuring that employee SG entitlements are paid, highlight the need for a firm resolve in deterring and punishing those few individuals who would seek to dishonestly avoid their lawful obligations.

Secondly, the aim should be to remove the incentives for fraudulent phoenix behaviour rather than just providing a remedy after the fact on a case by case basis. It is important to reduce the scope for phoenix operators to use unpaid taxes as a source of finance and to expose their personal assets to collection.

Finally, any options should seek to remove the attraction to dishonestly engage in phoenix activity by forcing company directors to take greater responsibility for tax debts (including indirect tax obligations such as GST and excise) and SG obligations and address the declining financial state of their businesses sooner — rather than waiting until the business becomes insolvent and the debt so large that it can't be repaid.

### **4.2 KEY REFORM OPTIONS**

The following section outlines a range of potential reform options. These options seek to strike the appropriate balance discussed above and could be implemented in a range of different configurations.

#### **4.2.1 Amend the director penalty regime**

The director penalty regime could be amended to overcome its limitations with respect to the avoidance of PAYG(W) obligations by fraudulent phoenix operators.

## **Automating liability based on the period of time for which debts remain unpaid**

As noted above, a limitation of the existing regime is its reliance on the issue of a director penalty notice to effectively crystallise the liability of a director. Therefore, a possible amendment to the regime could be to remove this requirement. Of course, simply imposing liability on all directors from the day on which the PAYG(W) liability remains unpaid by the company would be inappropriate and would impact on all directors, not just those engaged in fraudulent phoenix activity.

To strike a balance between creating an effective mechanism to curb fraudulent phoenix activity but not imposing liability on innocent directors, a director could be made liable for a penalty (by operation of law) in relation to a PAYG(W) liability that has remained unpaid for a certain period of time (for instance, three months). Within this period of time, a director would continue to be able to avoid liability for the penalty by taking an appropriate course of action (including placing the company into administration or liquidation). If a liability remains unpaid after this period, a director could not avoid a penalty.

In effect, this period of time would give an honest director time to address the issues that caused the non-payment of liabilities. This could include addressing a temporary lapse in business process or, if the non-payment relates to fundamental solvency issues, to seek advice and perhaps place the company into liquidation or administration if appropriate. This would be consistent with the original policy intent of the regime. Notably, however, directors who intentionally seek to gain from the non-remission of PAYG(W) amounts would find that the benefit they could derive would be limited to three months, thus reducing the incentive to engage in fraudulent phoenix activity.

## **A continued role for the director penalty notice?**

Moving to a regime in which liability is based on the age of the debt rather than some administrative action would not necessarily negate the role of the director penalty notice. Notably, maintaining the director penalty notice as an additional mechanism to crystallise a director's liability would enable the Commissioner to take action within three months of a liability being incurred. This would not be appropriate (indeed administratively feasible) in all cases. However, in instances where the ATO has identified a particular director who flagrantly continues to disregard the company's PAYG(W) liabilities, the timely issue of a director penalty notice could reduce the length of time that a director could benefit from the non-payment of PAYG(W) liabilities.

## **Are further amendments required?**

It will be important to ensure that any revised director penalty regime achieves the right balance between creating an effective disincentive to fraudulent phoenix activity on the one hand and not unduly targeting directors innocent of such activity. Of course, the regime would also need to remain true to its original policy intent of providing an incentive for all directors to ensure that their company complies with its obligations.

Arguably this balance may already be achieved through the proposed reasonable period (three months) during which the director would not be liable for a penalty. In addition, a director would continue to be able to access the existing defences to a penalty.<sup>20</sup>

Submissions are sought on whether a shift to an automated director penalty regime would achieve this desired balance. For instance, consideration could be given to whether defences to the director penalty regime should be made to mirror those contained in the Corporations Act in relation to insolvent trading.<sup>21</sup> Specifically, this would involve introducing a defence where a director could show that they had reasonable grounds to believe that the company's PAYG(W) obligations had been complied with. Arguably, such a defence would be of little effect in instances where liability only arises after a period of time (such as three months). After this period of time, it might be expected that a director has become aware of the actual state of affairs of the company.

Another potential limitation that could be placed on the operation of an automated director penalty regime would be to limit the period of time in which the ATO could commence action to recover the penalty. The limitation could be consistent with the period of time in which the Commissioner is able to amend an assessment for a company, which is currently four years.<sup>22</sup> Where the company had failed to report the liability, the ATO could have (for instance) four years from the date that they first discovered the liability.<sup>23</sup>

#### 4.2.2 Expand the director penalty regime

As noted above, a limitation of the existing director penalty regime is that it does not extend to all types of liabilities that are often left unpaid as a result of fraudulent phoenix activity. While extending the director penalty regime to cover liabilities such as SG, indirect taxes (for instance GST and excise) and even the company's own income tax would go beyond the original policy intent behind the regime (to replace the Commissioner's PAYG statutory priority) there may be justification for doing so. Certainly, in the context of SG amounts, there are arguably strong public interest grounds to increase the incentives for directors to ensure that their company complies with their SG obligations as there is a direct impact on the employee if they fail to do so.

While other taxation liabilities, such as indirect taxes (like GST and excise) and the company's own income tax, do not relate to the liability of another entity, their inclusion in an expanded and amended director penalty regime would nonetheless support its role as a disincentive for directors to engage in fraudulent phoenix activity.

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20 See section 222AOJ of the ITAA 36. Notably a director will not be liable for a penalty if they can show that (i) for some good reason they were not involved in the management of the business at the relevant time or that (ii) they took all reasonable steps to ensure that directors complied with their obligations (or that there were no such steps that could be taken).

21 See section 588H to the Corporations Act.

22 See subsection 170(1) of the ITAA 36.

23 This would also be consistent with amendments periods in the taxation law — in the case of fraud or evasion, amendment periods are unlimited.

## Amend estimate regime

If the director penalty regime were amended, consideration could also be given to ensuring that the estimate regime were updated to support the director penalty regime changes<sup>24</sup> and to ensure consistency.

With respect to ensuring consistency, if the director penalty regime were amended to incorporate a broader range of liabilities, it may also be appropriate to make corresponding amendments to the estimation regime contained in Division 8 of Part VI of the ITAA 1936. As noted above, this would permit the Commissioner to make an estimate of the outstanding liability and seek to recover those liabilities on the basis of that estimate. This would overcome problems associated with the delay in recovery of outstanding liabilities where the precise amounts of those liabilities need to be determined before recovery action can be commenced.

Expanding the estimate regime in this manner would go beyond the immediate need to address fraudulent phoenix activity. However, if the director penalty regime were amended to cover a range of liabilities it would be important to maintain consistency in the collection mechanisms relating to these liabilities. It should be noted that amendments to the estimation regime would not have any direct impact on the liability of a director and would merely expedite the Commissioner's ability to collect outstanding moneys.

### 4.2.3 Amend the promoter penalty regime

The promoter penalty regime could be amended to extend the concept of a tax exploitation scheme to include schemes to avoid payment of a tax liability, including SG payments. This does not address the problem of fraudulent phoenix activity directly but it would deter individuals who derive income through promoting the misuse of the corporate form and the privileges associated with limited liability. It might also form a useful adjunct to the other options discussed in this paper.

### 4.2.4 Expanding anti-avoidance provisions

Another option would be to ensure that the taxation law included provisions to overcome the GAAR's existing limitations with respect to fraudulent phoenix activity. This outcome could be achieved through additions to the existing GAAR or through the creation of a specific anti-avoidance provision targeted at fraudulent phoenix behaviour. As with the promoter penalty regime, amending the existing GAAR would require extending the concept of 'tax benefit' to capture the non-payment of a tax liability. If a new anti-avoidance provision were legislated, its application could be extended beyond income tax to encompass other liabilities that are evaded through fraudulent phoenix activity (such as SG, GST and other indirect taxes).<sup>25</sup>

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24 There are interactions between the estimate and director penalty regimes – see for instance Subdivision C, Division 9 of Part IV of the ITAA 1936.

25 Such an approach would need to take into account the fact that there are already general anti-avoidance rules that apply to certain indirect taxes — see, for instance, Division 165 of the *A New Tax System (Goods and Services Tax) Act 1999*.

Moreover, as there is little merit in undertaking recovery action against a company that has been liquidated, such an anti-avoidance provision could also enable the Commissioner to pursue the entity that has obtained the benefit from the phoenix activity. Exactly which entities would be pursued could be left to the Commissioner's discretion or broadly prescribed, possibly based on the associate/relationship rules in section 318 of the ITAA 1936, or the definition of 'groups' provided for in various state payroll legislation (see further below).<sup>26</sup>

While a limitation of this approach is that it could only be applied after the fact, once an entity had phoenixed, it has a number of advantages. The advantage of adopting an 'anti-avoidance' approach to address fraudulent phoenix activity is that, in addition to being able to draw upon the case law on the existing GAAR, it enables a distinction to be drawn between legitimate company failures and fraudulent phoenix activity, since it would apply only where the purpose of the activity is to obtain a tax benefit.

#### **Example of phoenix anti-avoidance provision**

A labour hire company belongs to a larger corporate group including a holding company and a company that holds all the plant and equipment of the group. The labour hire company accumulates a variety of taxation liabilities and, for the dominant purpose of avoiding the payment of those liabilities, the directors place the company into liquidation. After determining that the anti-avoidance provisions will apply, the Commissioner is able to commence recovery proceedings against other companies in the group.

The approach to make one entity liable for another entity's debt has been used in other jurisdictions, for example in state payroll legislation.<sup>27</sup> This legislation provides that all entities in a 'group' are automatically jointly and severally liable for the payroll obligations for another member of the group without the need for an initial determination as to the purpose behind the non-payment of the liability. In this respect there is a clear distinction between the proposed anti-avoidance approach and the approach adopted by the States. The use of such a grouping provision in Commonwealth legislation as a means of addressing fraudulent phoenix activity was suggested by the Cole Royal Commission.

### **4.2.5 Reinstate the 'failure to remit' offence**

Prior to the introduction of the PAYG(W) system in 2000, the ITAA 1936 included offence provisions for failure to remit amounts withheld under the former PAYE system. With the introduction of the PAYG(W) system the offence provisions were removed and replaced with an administrative penalty provision. A possible option to address the non-payment of PAYG(W) debts associated with fraudulent phoenix activity is to reinstate the failure to remit offence for PAYG(W), thereby permitting action to be taken against directors for the outstanding amounts. This would be achieved through using the failure to remit offence alongside section 8Y of the *Taxation Administration Act 1953 (TAA 1953)* (to make directors liable for taxation offences committed by their company) and section 21B of the *Crimes Act 1914* (which allows a Court to order a person to make reparation for an loss to the Commonwealth that results from the commission of an offence). Depending on the type of

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<sup>26</sup> What is a 'group' is defined broadly to include, *inter alia*, related bodies corporate, employers who have common employees, commonly controlled businesses and shareholders of a corporation.

<sup>27</sup> See for instance Part 5 of the *Payroll Tax Act 2007* (NSW).

offence provisions created, the *Proceeds of Crime Act 2002* could also be engaged to trace the assets of the director.

Reinstating a failure to remit offence would actively work against fraudulent phoenix activity by:

- acting as a disincentive for directors who are planning not to remit withheld amounts to the Commissioner; and
- disqualifying a person from future involvement in managing corporations by operation of the Corporations Act (Part 2D.6).<sup>28</sup>

Reliance on section 8Y of the TAA 1953 would also ensure that directors who were in no way involved and were not knowingly involved in failing to remit PAYG(W) amounts were not found guilty of the offence.<sup>29</sup>

The case of *Gould v FCT*<sup>30</sup> shows that a failure to remit offence can be used to hold directors liable for unpaid liabilities of a company, notwithstanding that they have avoided liability for a director penalty.

#### **Case Study: *Gould v FCT* (1998)**

In *Gould v FCT* a director placed his company into liquidation after receiving a director penalty notice and in doing so avoided a director penalty for the unpaid PAYE liability of the company. However, he was convicted by virtue of section 8Y of the TAA 1953 in relation to the company's failure to remit PAYE amounts to the Commissioner. The Commissioner then asked the Court to use section 21B of the *Crimes Act 1914* to require the director to make reparation for the unpaid PAYE amounts. The Court held that the use of section 21B in this way was not inconsistent with the ability of a director to avoid penalties by placing the company into liquidation.

A similar offence provision could also be introduced in relation to employers that fail to comply with their SG obligations.

However, the effectiveness of reinstating a failure to remit offence may be limited due to its reliance on the availability of Commonwealth Director of Public Prosecution resources.<sup>31</sup>

It should be noted that the Council of Australian Governments (COAG) has agreed to increased harmonisation across Australian laws which impose personal criminal liability on directors for corporate misconduct. This project is one aspect of COAG's work towards a seamless national economy. As part of this work, the Commonwealth Government has undertaken to audit all Commonwealth laws against a set of principles which will underpin

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28 This provides, amongst other things, that a director found guilty of certain offences are automatically disqualified from managing a company — see section 206B.

29 Subsection 8Y(2) provides a list of defences for an officer of a corporation to avoid liability for an offence committed by the corporation.

30 1998 (98 ATC 4946).

31 This may depend on the level of penalty imposed for the offence. For some lesser offences, agencies such as the ATO are able to undertake their own prosecutions.

the reform of personal criminal liability for corporate fault. This audit will be progressed throughout 2010.

#### **4.2.6 Deny PAYG(W) credits**

As noted above, one of the benefits of fraudulent phoenix activity is the claiming of credits by directors of amounts withheld under the PAYG(W) system that are never remitted to the Commissioner. While the Commissioner can and does deny credits when there is evidence that amounts have not been withheld, this approach cannot be applied where amounts have been withheld, but not remitted.

Another possible approach would be to include a specific provision in the law that denies directors (and potentially close relatives<sup>32</sup>) credits where the withheld amounts have not been remitted by the company. This would ensure that a director, who has a responsibility to oversee the financial affairs of the company, cannot profit personally when the company's financial obligations have not been fulfilled.

It should be noted that the effectiveness of such a provision would be limited by:

- its capacity to capture directors or their relatives who are innocent of any fraudulent behaviour (however, including a discretion to enable the Commissioner to allow claims for credits where it is fair and reasonable to do so could assist in avoiding this problem); and
- it being dependent on the ATO's ability to identify taxpayers who are claiming PAYG(W) credits that have not been remitted.

#### **4.2.7 Offence of claiming non-remitted PAYG(W) credits**

As an additional disincentive for directors to claim credits for non-remitted PAYG(W) amounts it could be made an offence to do so. Such a provision would be aimed at directors who persistently claim such credits in the knowledge that they had not been, and would never be remitted.

#### **4.2.8 Expand the scope for disqualification of directors**

Part 2D.6 of the Corporations Act currently provides a range of bases for disqualifying directors from managing a corporation. This can occur automatically<sup>33</sup>, by a Court<sup>34</sup> or by a determination by ASIC<sup>35</sup>. ASIC's power to disqualify a director arises when it can be shown that the director had managed two or more failed corporations.

In 2004 the Parliamentary Joint Committee on Corporations and Financial Services (Corporate Insolvency Laws: a Stocktake) recommended that disqualification of a director from managing a corporation not be subject to a requirement to have managed two or more failed corporations. If this was implemented, a Court, or ASIC could disqualify a person from

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32 This could be introduced to guard against directors merely 'employing' close relatives and using payments to them as a means of gaining a benefit.

33 See section 206B of the Corporations Act.

34 See Section 206C, D and E of the Corporations Act.

35 See section 206F of the Corporations Act.

being a director if the relevant company had been wound up and the conduct of the person, as a director of the company (either taken alone or taken together with conduct as a director of any other company) makes them unfit to be concerned in the management of a company.

This option would combat fraudulent phoenix activity by:

- allowing regulators to stop phoenix operators liquidating two or more companies before they are liable to disqualification; and
- avoiding costly court expenses which are part of court imposed disqualification proceedings (if the decision to disqualify rested with ASIC).

However, this approach may:

- be considered too broad to combat fraudulent phoenix activity;
- act as a disincentive for directors to take entrepreneurial risks (however, by only permitting disqualification on the basis of the conduct that made the individual unfit to be involved in the management of the business, arguably 'innocent' directors would not be disqualified); and
- be easily avoided by the use of shadow directors (although not formally declared as a director, a shadow director takes on the role of a director in the management of a company), which is a common phenomenon amongst fraudulent phoenix activity.

#### **4.2.9 Restrict the use of similar name or trading style by successor company**

The use of a similar trading name and trading style of successor companies is often a key indicator of fraudulent phoenix activity. A measure which may make it harder for phoenix operators to abuse the corporate form is to restrict the adoption of the same or a similar name for the successor company as the company that was liquidated.

If the phoenix company adopts the same or a similar name as their previous incarnation, the directors of the liquidated company would become liable for the new company's debts. This forms part of insolvency law in the United Kingdom and New Zealand.<sup>36</sup>

This measure would deter phoenix operators from liquidating indebted companies by:

- hindering their ability to transfer their business operations to a new company to continue the business venture;
- making directors personally liable for the debts of the liquidated company; and
- targeting one of the key indicators of fraudulent phoenix activity.

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<sup>36</sup> See section 216 and 217 of the *Insolvency Act 1986 (UK)* and section 386A, B and C of the *Companies Law Act 1993 (NZ)*. Note that the New Zealand legislation actually defines a phoenix company as "in relation to a failed company, a company that, at any time before, or within 5 years after, the commencement of the liquidation of the failed company, is known by a name that is also (a) a pre-liquidation name of the failed company; or (b) a similar name." In addition to making directors liable for debts when they are involved in phoenix activity, it also makes it an offence for a director of a failed company to be involved in a phoenix company (punishable by five years imprisonment or a \$200,000 fine).

On the other hand, a limitation of this approach is that it would be easily circumvented by the successor company adopting a dissimilar name to the previous entity (though arguably this is still a disincentive to fraudulent phoenix activity, as the adoption of a dissimilar name for the successor company would be a significant impediment to effectively transferring the business to a new company and would impose additional, often substantial costs on the new entity).

## 4.3 OTHER OPTIONS

### 4.3.1 Bond provision

As noted above in paragraph 3.1.5, there are significant limitations in applying the existing bond provision (section 213 of the ITAA 1936) to anticipated fraudulent phoenix activity. One possible solution would be to amend the bond provision to empower the Commissioner to require a bond, not only in relation to income tax, but also in relation to other liabilities that are often avoided through phoenix activity.

In addition, a more substantial penalty for failing to provide the bond would need to be imposed to ensure that it acted as a real disincentive.<sup>37</sup> For instance, the non-provision of a bond might result in a penalty of one year imprisonment (which would translate to 60 penalty units for natural persons or 300 penalty units for a body corporate). As noted above section 8Y of the TAA could also be used to pursue a director for the offence.

A company would be required to pay a bond from its own capital or through using a third party bond provider. If the bond could not be provided, this would reflect the inadequate resourcing of the company or the fact that its credit worthiness was such that it was unable to provide a bond using a third party. In these circumstances, it is questionable whether a company should be carrying on a business.

Amending the bond provision could act as a real disincentive for future or anticipated phoenix activity. However, in broadening its application to a range of taxes and in strengthening the penalty, it would be appropriate to limit the amount of the bond, and also to limit the circumstances in which the bond could be required. The amount of the bond, for instance, could be limited to the liabilities that the company is expected to accrue over a certain period (say, three months), having regard to things such as the size of the business, the nature of the business and the number of employees of the business. Moreover, the Commissioner could be limited to requesting the bond in circumstances where it is reasonable to expect that the company is unlikely to be able to meet its obligations, having regard to a range of factors that may indicate a propensity to fraudulent phoenix activity.

### 4.3.2 Adopt the doctrine of inadequate capitalisation

The judicial doctrine of inadequate capitalisation has been used in the United States to lift the corporate veil where a company sets up a subsidiary with insufficient capital to meet the debts that could have reasonably be expected to arise. The James Hardie Special

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<sup>37</sup> This would need to be consistent with the Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers (available from [www.ag.gov.au](http://www.ag.gov.au)) which recommends that a maximum penalty should be adequate and appropriate to act as an effective deterrent to the commission of the offence to which it applies.

Commission of Inquiry Report gave some support to the adoption of the doctrine in Australia.

This option could be implemented by amending the Corporations Act to require other companies in a group to make restitution to the subsidiary and creditors upon insolvency if the subsidiary is found to have been deliberately or knowingly undercapitalised. A variation on this could be to permit a creditor (such as the ATO) to apply for the winding up of a company on the grounds of inadequate capitalisation.

This option could be used to curb fraudulent phoenix activity by:

- providing a means for creditors of a group company to access the assets of related companies; and
- targeting misleading or deceptive conduct where group companies were incorporated merely to avoid or minimise liabilities.

However, limitations of this proposal are that it could:

- reduce the level of start-up businesses through increased costs caused by the need to conduct due diligence on the capitalisation of subsidiary companies;
- transfer the risk from the stakeholders of the group company to the stakeholders of related companies who are not in as strong a position to manage the risk; and
- be undermined by the difficulty of proving an intent to undercapitalise and defining the term 'undercapitalised'.

It should be noted that the doctrine of inadequate capitalisation is still unclear and controversial in the United States.

## QUESTIONS FOR CONSULTATION

The Government invites interested parties to provide comments and feedback on any aspect of this discussion paper, in particular the need for legislative amendments to address fraudulent phoenix activity and the relative merits of the proposals outlined above. In addition to these two broad issues, the Government would welcome comments based on the questions below.

1. If amendments were made to the director penalty regime to effectively 'automate' director penalties, what period of time would it be reasonable for a director to avoid liability to ensure that legitimate directors who may be facing adverse economic conditions or business cycles are not unduly affected? Is three months a reasonable period?
2. If this 'automated' approach were taken with the director penalty regime, would there be a continuing role for the director penalty notice?
3. If the law were amended to 'automate' director liabilities, should any additional limitations on the operation of the regime be imposed? Notably:
  - a) Does the period of time in which a director is not held liable for a penalty (three months is suggested), along with the existing defences, ensure the right balance between providing an incentive for directors to cause their company to comply with their obligations and not imposing penalties in inappropriate circumstances?
  - b) Is there a need for additional defences to the regime, modelled on those in the Corporations Law relating to insolvent trading? What undesirable consequence would such a defence seek to avoid?
  - c) Should the period of time in which the ATO has to recover the penalty be limited, for instance, to four years (consistent with usual the amendment period for companies)?
4. Should the director penalty notice regime be expanded to include an additional range of payments, taxes and duties? For instance, should it be expanded to include Superannuation Guarantee amounts, the company's own income tax and/or indirect taxes such as GST and excise?
5. If the director penalty notice regime were expanded to cover a range of liabilities, should the estimation regime in Division 8 of Part VI of the ITAA 1936 be similarly amended?
6. Should the promotion of fraudulent phoenix behaviour be made subject to the promoter penalty regime?
7. Should the taxation law include anti-avoidance provisions that give the Commissioner the ability to trace the benefit derived from fraudulent phoenix activity to individuals and entities other than the liquidated company?
8. Would it be appropriate to remove the requirement that a director has managed two or more failed corporations before ASIC can disqualify a director?
9. Should an offence for the non-remittance of PAYG(W) amounts be reintroduced into the taxation law?

10. Should a similar offence provision be created in relation to non-compliance with SG obligations?
11. Is the denial of PAYG withholding credits to directors by the ATO an appropriate mechanism to deal with fraudulent phoenix behaviour? Should it extend to all directors and close relatives of the director (provided that the Commissioner is given a discretion to allow PAYG(W) credits where it is appropriate to do so)?
12. Would a restriction on the use of a similar name or trading style be an effective mechanism in curbing fraudulent phoenix activity?
13. Should it be an offence for directors to claim non-remitted PAYG(W) when the company has not remitted PAYG(W)? As this approach would target both fraudulent phoenix directors as well as legitimate directors, would it achieve the right balance between protecting revenue and protecting the interests of legitimate directors?
14. Is it appropriate for the ATO to require a bond to be paid in relation to an expanded range of liabilities if fraudulent phoenix activity is suspected or expected? What would be an appropriate amount? Should it be referable to three months of anticipated tax liabilities? Six months?
15. Do you have any other suggestions that would assist to deter entities from engaging in fraudulent phoenix activity?

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## ABBREVIATIONS

AA Fund	Assetless Administration Fund
ASIC	Australian Securities and Investment Commission
ATO	Australian Taxation Office
CDPP	Commonwealth Director of Public Prosecutions
COAG	Council of Australian Governments
GST	Goods and Services Tax
GST ITC	GST input tax credits
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
PAYE	Pay As You Earn
PAYG(W)	Pay As You Go Withholding
TAA 1953	<i>Taxation Administration Act 1953</i>

## **APPENDIX A: EXISTING MECHANISMS TO ADDRESS FRAUDULENT PHOENIX ACTIVITY IN AUSTRALIA'S CORPORATE LAW REGIME**

Australia's corporate law regime is based on the separation of ownership and control with the *Corporations Act 2001* (Corporations Act) imposing certain duties on directors to ensure their loyalty to the company. These statutory duties are in addition to those duties which directors have under the general law as fiduciaries.

If a director is involved in phoenix activity, they may be in breach of a number of directors' duties, in particular the duty of good faith, duties concerning proper use of information or position and the duty not to allow a company to continue to incur debts where the company is insolvent. Fraudulent phoenix activity may also involve voidable transactions or contraventions of the provisions of Part 5.8A of the Corporations Act aimed at protecting employee entitlements. In these circumstances civil recovery mechanisms, and other general features of the law that seek to protect creditors and company members against unscrupulous operators may be initiated by creditors.

### **SANCTIONING DIRECTOR MISCONDUCT**

The Corporations Act does not define phoenix activity as such, but provides sanctions where a director has contravened certain provisions. The Act provides for the disqualification of directors from managing corporations where they have been involved in multiple corporate failures. To ensure adequate coverage of the provisions, the law takes a broad functional approach to what constitutes 'management'. It includes communicating instructions or wishes to the directors of a corporation intending those directors to act in accordance with those instructions or wishes, or knowing that such directors are accustomed to do so.

Under the disqualification provisions, the Australian Securities and Investments Commission (ASIC) is able to have a person disqualified as a director for up to five years without the need for court action, where that person has been a director of two or more corporations that have been wound up within a seven year period, and a liquidator has reported that the corporations are unable to pay more than 50 cents in the dollar to unsecured creditors. ASIC may apply to a court to have a 5 year disqualification order extended by up to 15 years (ie to 20 years). In addition, a court may disqualify a person for 20 years, if the court is satisfied both that the person was responsible for the failure of two or more corporations, and that the disqualification is justified.

If a person manages a corporation whilst disqualified, they commit an offence and may incur a fine or a term of imprisonment.

A breach of directors duties may also result in other sanctions including significant civil and criminal penalties, compensation orders, and (in some cases) imprisonment.

### **ADMINISTRATIVE PROGRAMS AND LAW ENFORCEMENT**

There are a number of ASIC administrative programs in place to deter fraudulent phoenix company activity. They include the Assetless Administration fund, the National Insolvent Trading Program, the Liquidator Assistance Program and company surveillance programs

undertaken by ASIC. These programs can lead to the banning of directors or, in some cases, more serious action, such as fines or prosecutions. The kind of breaches that these programs seek to target include fraudulent phoenix company activities, breaches of directors' and officers' duties, continuing to take part in the management of a company whilst disqualified, failure by a director to take reasonable steps to ensure that the company maintains adequate books and records, insolvent trading, fraud, misrepresentation and theft of property.

## **THE ASSETLESS ADMINISTRATION FUND**

The Assetless Administration Fund finances preliminary investigations by expert liquidators of companies, selected by ASIC, that have been left insolvent with little or no assets. Since the AA Fund was launched on 22 February 2006 to 30 September 2008, ASIC approved 385 applications for funding of reports on potential director banning matters. An average of \$5,227 has been committed to each approved application. As at 4 October 2007 liquidator reports funded by the AA Fund have led to 68 directors being banned.

ASIC has also approved many applications for funding for reports on potential breaches of the Act. The average amount of funding committed to an approved application is approximately \$41,000. Potential breaches involved in these applications include:

- breaches of directors' and officers' duties (s180-184);
- continuing to take part in the management of a company whilst disqualified (s206A);
- failure by a director to take reasonable steps to ensure that the company maintains adequate books & records (s344);
- unauthorised use of an officer's powers following the winding up of the company (s471A);
- insolvent trading (s588G);
- fraud, misrepresentation or theft of property (s590);
- application of money to be held on trust (s722); and
- lodging a false or misleading document (s1308).

## **ASIC'S NATIONAL INSOLVENT TRADING PROGRAM**

ASIC's National Insolvent Trading Program is in its fourth year. It aims to have company directors actively manage their company's financial position and act early or seek early advice when financial difficulties arise. The program reduces the risk of insolvent trading, with its potentially serious impact on creditors and the business community, and assists directors of companies in financial difficulties to improve the company's overall performance.

In 2007/2008 ASIC conducted surveillance visits of 240 companies (including a number of related companies). Twenty-eight companies had an external administrator appointed following a visit.

Outcomes ranging from companies seeking professional advice or obtaining an accurate financial position, through to restructuring, refinancing or raising further capital, have been achieved through this Program.

### **ASIC'S LIQUIDATOR ASSISTANCE PROGRAM**

ASIC's liquidator assistance program aims to ensure directors of companies in external administration comply with their obligations to provide information about companies they managed, for example about the location of company records and assets and the provision of information relating to the company's finances and history. Directors who fail in these obligations immediately find themselves the subject of ASIC initiated court action. This program facilitates the timely and efficient process of receivership, administration or winding up of companies under external administration.

In 2007/2008, 574 company officers were prosecuted in relation to 1067 external administration assistance offences. Fines and costs of approximately \$980,000 were ordered from these prosecutions.

ASIC has the ability to seek injunctive relief to prevent company assets being dissipated. It can also utilise its power to seek the reinstatement of companies that have been deregistered.