Australian Institute of Credit Management
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Collection Realities

"COLLECTION REALITIES FOR UNSECURED CREDITORS"

[OR "THE ABOLITION OF CROWN PRIORITY" OR "THE IMPACT ON THE ATO OF THE VOLUNTARY ADMINISTRATION PROCEDURE"]

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[NOTE: THIS TRANSCRIPTION WAS DONE BY PETER KEENAN IN NOVEMBER 2008. I HAVE HAD THIS SEMINAR PAPER SINCE 1993. I HAVE PUBLISHED THE PAPER BECAUSE IT CONTAINS IMPORTANT HISTORICAL INFORMATION ABOUT THE CONTROVERSIAL ABOLITION OF THE CROWN/GOVERNMENT PRIORITY FOR TAXATION DEBTS.]

Thank you for the opportunity of addressing you today. As you are aware, the Government has introduced changes to the Corporations Law and to the Income Tax Assessment Act that will impact on the way the Commissioner deals with unremitted amounts. The changes are significant, particularly for directors of companies, and this seminar enables me to let you know what we are looking to put in place to deal with those changes.

Clearly, the loss of the priority and the concept of being able to estimate a liability and recover that the estimate is something that will require us to rethink the way we do things, particularly in light of the Corporate Law changes that introduced the concept of voluntary administration. I must caution that we at the ATO are still coming to grips with the changes and I see that there clearly needs to be some attitudinal change on our part, as well as on the part of secured creditors, if the proposals by the Government are to work.

I suppose you are thinking it is easy for me to look to a change in attitude from secured creditors now that the ATO has lost its priority, but I think all creditors need to take note of recent trends that endeavour to facilitate corporate rehabilitation and restructure, rather than corporate death. The objectives of the new part 5.3A of the Corporations Law are:

> *"to provide the business, property and affairs of an insolvent company to be administered in a way that:*
>
> *a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or*
> *b) if it is not possible for the company or its business to continue in existence - results in a better return for the company's creditors and members than would result from an immediate winding up of the company."*

It would seem to me that the concept of a better return for company creditors will be a significant incentive for those creditors to consult and co-operate with an administrator when trying to decide the fate of a company.

However, before dealing with the changes, I have been asked to give an overview of the Commissioner's priority and the circumstances that led to its abolition.

In December 1992, the then Attorney-General and the Treasurer issued a joint press release indicating the Government intended to abolish the Commissioner's priority in an insolvency. The ministers were concerned that the priority often meant that there was little or nothing left for employees and other creditors when a business was put into some form of insolvency. It was also felt that the proposed reforms to the Corporations Law, in particular, the voluntary administration procedure, would be easier to use if the priority was removed.

The announcement of the removal of the Commissioner’s priority was basically another step in a continuous review which has seen the gradual erosion of the concept of Crown priority over quite a number of years. The priority of Crown debts stems from the Royal prerogative, recognized at common law, that the debts of the sovereign are superior to and should be paid in priority to those of the subject. The concept being that if there are insufficient funds to pay both, the Crown prevails.

The question of continuing the priority of Crown debts has been the subject of a number of enquiries both in Australia and overseas and has been a matter of some debate for most of this century. Relevant recent enquiries include

- The 1962 Review of the Bankruptcy Law of the Commonwealth by the Clyne Committee, which strongly recommended that priority for income tax should rank last of the specified priorities rather than first.

- The 1978 report on Priority of Crown Debts by the Senate Standing Committee on Constitutional and Legal Affairs, which recommended the total abolition of all Crown priority.

- The 1982 UK Cork Committee Report on Insolvency Law and Practice which argued in favour of the abolition of Crown priority and specifically commented that moneys due to the Crown in respect of unpaid tax ought not to be paid in an insolvency in priority to other debts. It is interesting to note that the Committee was prepared to allow limited priority for taxation moneys collected on behalf of the Crown (such as PAYE, national insurance contributions, value added tax and car tax).

- The 1986 report of the Canadian Advisory Committee on Bankruptcy and Insolvency on Proposed Bankruptcy Act Amendments which recommended that the Crown priority should be totally abolished under both federal and provincial jurisdiction and that all claims of the Crown would rank in the same priority as those of unsecured creditors.

- The 1988 Australian Law Reform Commission’s "General Insolvency Enquiry" (the Harmer Report) which also recommended the abolition of the priority, partly on the basis of the incompatibility with the proposed new voluntary administration procedure.

I note that in response to the 1978 report on Priority of Crown Debts, the Government restricted the operation of the Crown priority for "tax" debts to section 221P (dealing with unremitted pay as you earn or PAYE deductions) and a section 221YU (dealing with unpaid withholding taxes) of the Income Tax Assessment Act. These exceptions recognized the particular nature of the amounts deducted from funds due to payees and reflected the approach in many overseas jurisdictions.

While restricting the priority to these particular class of deductions only, the Government also amended section 221Q of the Act and made it mandatory for the Commissioner to allow full tax instalment credit to employees, irrespective of whether the employer remitted the amount deducted to the Commissioner.

The operation of the Crown priority in the Act was later extended by the inclusion of section 221YHJ (dealing with unremitted prescribed payment deductions) in 1983 and section 221YHZD (dealing with unremitted natural resource and other unattributed income payment deductions like royalties) in 1986.

The Commissioner has successfully argued to maintain his priority despite criticism and

moves for abolition over many years. Some of the arguments used, which are, to some extent, still relevant today are:

- **Taxation debts are owed to the community rather than to an individual**
- **The revenue of the Crown must be protected**
- **The relationship between the Commissioner, taxpayers and persons authorised to make deductions is a statutory one (not contractual) and is necessary to give effect to and safeguard the fundamental nature of "pay-as-you-earn" taxation.**
- **The Commissioner effectively indemnified employees by being required to allow tax instalment credit even if the employer fails to remit amounts deducted.**
- **It would be contrary to public policy to allow a person authorised to make deductions to use the moneys deducted to meet ordinary trade debts.**
- **The amounts that had been deducted are not the funds of the employer or payer, but actually amounts withheld from the wages or payments due to particular employees or payees.**
- **And, most importantly, the Commissioner is an involuntary creditor because he is not in a position to make a choice about extending credit to employers or payers. He cannot restrict credit in the way a private creditor can by withholding stock, turning off power or cutting off the telephone. He cannot insist on security before "allowing" credit, nor can he require existing liabilities be satisfied before new ones are created. In fact, the Commissioner is at a distinct disadvantage, because employers or payers are required by law to deduct amounts on behalf of the Commissioner and they commit an offence if they do not comply with these requirements. (They also commit an offence if they do not remit.)**

Over the years, the major application of Crown priority and the area of most significance to the Commonwealth revenue was in relation to unremitted PAYE deductions. The priority was obtained under section 221P of the Act when the control of the property of an employer had passed to a trustee. The ambiguity of the provision combine with its narrow interpretation by various judges had given rise to arrangements circumventing the law in a number of ways, like:

- a chargee taking a charge over part of an employer's property or alternatively, appointing a receiver over only some of the employer's assets. There was some doubt whether the priority could be invoked, as a trustee or receiver did not have the requisite degree of control;
- a chargee electing to retain his power of sale and not including a power of sale in any instrument appointing a receiver or alternatively, expressly prohibited a receiver from exercising the chargee's statutory power of sale under the various State real property enactments. Both actions prevented a receiver from obtaining sufficient control of the employer's assets, which effectively defeated the priority;
- a chargee appointing separate or multiple receivers, each with control of different parts of the employer's property; or
- appointing a person other than a trustee, as defined, to take charge of the assets. Courts had held that a provisional liquidator, a chargee, the agent of a mortgagee in possession, a creditor and a receiver without a power of sale, were not trustees for the purposes of the priority.

The Government’s preoccupation with the need to establish a new, national structure for administering companies and securities regulation during 1989 and 1990 did not allow it to address the recommendations in the Harmer Report until the latter part of 1991. At that time, the Attorney-General sought the Treasurer’s approval to put forward legislation to abolish the priority.

I suppose at this point, the Commissioner was on a hiding to nothing. He had argued successfully over the years to maintain his priority, but the increase in insolvencies in the latter part of the 80s, which had highlighted a number of deficiencies with the priority and drawn criticism from the Courts, together with the significant changes for dealing insolvency proposed in the camp Harmer Report, tended to put the writing on the wall.

There had also been calls for abolition of the priority by:

- several Ministers;

- employees, whose claims for holiday pay and long service leave could not be paid because of the Commissioner’s priority claim;

- the union movement;

- insolvency and accounting practitioners, including through the press;

- creditors, who argued that the ATO had used the priority as an excuse for inactivity.

In face of the sustained opposition to the priority, the Commissioner needed to rethink his position with some objectivity. This objective rethink led to the conclusion that:

- the priority was hard to use effectively, making insolvencies more dramatic than they need be;
- the priority was often avoided by costly and inefficient business structures. It distorted lending practices by promoting inefficient practices solely designed to avoid the priority (for example, negative pledge lending);
- the burden of the priority was often borne by trade creditors and employees, rather than those who should have remitted the amounts deducted in the first place. The disproportionate losses consequently suffered by creditors and employees had the potential to set off a chain reaction of insolvency in a local community, with a significant impact on employment and the social security system;
- the legislation granting the priority was not very effective in securing the timely recovery of non-remitted amounts and was reactive in that it did not take effect until an individual or company was made bankrupt or placed in liquidation. It put no pressure on directors of companies (or on non-corporate employers/payers for that matter) to remit amounts that had been deducted;
- generally, the amount recouped under the priority was comparatively minimal (estimated to be between $40 and $65 million per annum);
- the existence of the priority discourage creditors from appointing receivers and led to a failure in many instances to have insolvent companies dealt with quickly and effectively;
- the priority had the potential for seriously prejudicing the success of the new scheme of the voluntary administration of insolvent and near insolvent companies proposed in the Corporate Law Reform Bill 1992.

It was clear that the Commissioner could not sustain his claim to priority for payment of non-remitted amounts. However, he was concerned to ensure that any loss of the priority would be accompanied by legislation that enabled him to take more timely action to recover unremitted amounts. He was also concerned to ensure there would be no adverse impact on the revenue.

In a joint submission with officers from the Department of the Attorney-General, he put forward a proposition to Government that the priority should be replaced with a new approach which:

- assisted employers or payers to tackle solvency difficulties early, which should effectively stop tax debts escalating;

- focused on those who are responsible for the payment of unremitted amounts and avoided putting undue burdens on employees and others; and

- allowed overdue amounts to be recovered more quickly by streamlining recovery procedures.

The new arrangements, which received Royal Is sent on 16th of June 1993 as the *Insolvency (Tax Priorities) Legislation Amendment Act 1993:*

- removed the priority under sections 221 P. (PAYE), 221YHJ (PPS), 221YHZD (natural resources and other unattributed income) and 221YU (withholding tax) of the Income Tax Assessment Act for debts that may become payable after 30 June 1993. The priority does not now apply to unremitted PAYE deductions made after 14 June 1993 for an early remitted, or to unremitted PAYE deductions made after 31 May 1993 for other remitters. The priority will continue to apply to unremitted amounts deducted prior to these dates and due for payment prior to 30 June 1993.

- will enable the Commissioner to make an estimate (based on anything he thinks relevant) of the unremitted amounts when the time for payment has passed, that is, he now does not have to establish the actual amount deducted and not remitted before commencing action to recover. He can recover the estimate, which is provable in a bankruptcy or liquidation.

- if the Commissioner makes an estimate (or estimates), written notice must be sent to Person (which includes a company) against whom the estimate is made. The person will have seven days in which to notify the Commissioner of the actual amount deducted (by way of a statutory declaration) and to pay that amount. An estimate will be reduced or revoked to reflect information contained in a statutory declaration (or affidavit where court proceedings for recovery have been initiated).

- the estimate can be reduced or revoked at any time, but if it is reduced or revoked for any reason other than as a result of information provided in a statutory declaration, the Commissioner must send a notice to the persons setting out the underlying liability and the reduced estimate.

- a decision about whether to make, reduce or revoke an estimate, or about the amount (or reduced amount) of an estimate, is not reviewable under the AD (JR.) Act. The reason for this is that a person has an absolute right to vary the amount of an estimate by completing a statutory declaration (or an affidavit where court proceedings for recovery have been initiated).

- the liability to pay an estimate will be separate and distinct from the underlying liability. However, the underlying liability and the estimated liability (and additional taxes imposed) are "parallel liabilities" (that is, if either one is paid or partially paid, the other is reduced by the same amount).

- additional tax for late payment will apply to an estimate and will be calculated from the due date of the underlying liability. The rate of penalty will be the same as for the underlying liability, for example, 20% flat and 16% per annum for unremitted PAYE deductions.

- if a company does not meet its obligations to remit amounts deducted and does not enter into voluntary administration under Part 5.3A the Corporations Law, or does not go into liquidation, directors will be automatically personally liable to pay a penalty equal to the amounts not remitted (or the amount of an estimate).

- a penalty will only be recoverable from a director if the Commissioner gives the director notice of penalty.

- the penalty on directors will be automatically remitted if the company

    - pays the unremitted amount; or
    - enters into a payment agreement with the Commissioner (see next point), or
    - has an administrator appointed under sections 436A, 436B or 436C of the Corporations Law, or
    - begins to be wound up within the meaning of the Corporations Law.

- if the Commissioner enters into a payment agreement with the company and the company does not comply with the terms of that agreement, the directors will be personally liable to pay the amount still outstanding under the agreement. The Commissioner does not have to notify the directors who will again become personally liable when an agreement is breached.

- directors will be indemnified by the company or by anyone else the Commissioner could have sued for recovery in relation to any amounts they are required to pay as a penalty or as additional tax for late payment.

- there are defences available for directors to avoid personal liability. If a director can show that because of illness or for some other good reason he or she did not take part in the management of the company at the relevant time, or, if they did, they took all reasonable steps to ensure the company complied with its obligations, then they can avoid the liability.

The changes to the Income Tax Assessment Act are designed to complement the changes to the Corporations Law and in particular, voluntary administration under the new Part 5.3A. This form of administration is intended to be comparatively inexpensive, easy to commence and quick. I understand that under this part, it is possible for a deed of arrangement to be executed and successfully carried out without any reference to a Court. It is also possible for a company to be wound up without reference to a Court if the deed is not approved by creditors or, if an approved deed subsequently fails.

However, the Court has very wide ranging powers of supervision over the new form of administration, which will normally only be exercised on the application of one of the interested parties. The Court has the power to:

- order that the administration period ends;
- extend the administration period;
- restrict action by secured creditors, lessors or owners;
- limit the rights of secured creditors, owners or lessors beyond the administration period;
- void, vary, validate or terminate any deed of arrangement;
- make orders to protect the interests of any creditor, and
- make any order it thinks appropriate about how the legislation is to operate in relation to a particular company.

It would seem to me the new form of administration is likely to be more relevant to the small to medium sized business which, in the past, has tended to cease trading long after it should have, with the result that there was very little, if anything, returned to unsecured creditors in the resulting liquidation. There is now clearly an incentive for directors to appoint an administrator when a company is in trouble. In fact, in a lot of instances where the Commissioner has issued a penalty notice to directors, this may be the only avenue open for them avoid personal liability.

However, the success of an administration to rehabilitate a company and increase the return to creditors will depend on the attitude of the administrator and the major secured debenture holders. The possibility of rehabilitating a company or saving a business through the administration procedure relies upon commercial factors, not the least of which will be the need for directors and the administrator to address the attitude of debenture holders to their existing security and to assess their willingness to remain as a source of finance.

As I see it, there are some positive impacts of the new form of administration for secured creditors. These can be summarised as follows:

- an indemnity is not required
- the administration restricts other secured creditors, lessors, landlords, retention of title stock owners from taking precipitate action (which the secured creditor may be unable to prevent into receivership);
- it recognizes that the primary responsibility for detection of financial problems and for taking corrective action rests with the directors rather than with the secured lenders;
- a compromise reached with an unsecured creditor may enable the secured creditor’s customer to continue operating (which is often not possible in a receivership);
- it can halt any winding up proceedings (receivership does not);
- if there is genuine uncertainty about a company's continuing viability and financial prospects, the deed can allow the company to continue trading with its affairs being controlled by an independent administrator, without the secured lender being the party ultimately responsible for the costs and expenses of the administration (although these would rank the priority over the lender’s floating charge); and
- a debenture holder with a wide ranging charge may opt out of administration entirely, by enforcing the charge or otherwise appointing a receiver within 10 business days of the administrator's appointment.

Of course, there will be some disadvantages for secured creditors under the new arrangements. The return from floating charge assets may be eroded because of the indemnity for the administrator’s fees, costs and expenses, the secured creditor will be prevented from dealing with its assets for the administration period, and there is potential for the secured creditor’s rights to be restricted for an indefinite period by Court order (only if the secured creditor has not opted out within the allowed time frame).

Unsecured creditors will benefit under the new arrangements in the following ways

- the administrator will be looking to the interests of all creditors when making its report and recommendations, not just the interests of the secured creditors or a particular creditor that may have sought to appoint him or her;

- representation on the committee of creditors will enable unsecured creditors to have a consultative role immediately a voluntary administration begins;

- secured creditors will be better informed by reason of the administrator's investigation report required to be furnished with the notice of creditors meeting;

- creditors will have a say about whether a company should go into liquidation, compared with the present situation where in a potential voluntary winding up the members determine whether a company should be wound up;

- the appointment of an administrator at an early stage should lead to better returns creditors;

- the onus will be on creditors to ensure that their presence at creditors meetings called for the purpose of deciding the company's future that the proceedings adopted are bona fide and to stop any attempts at contrived or artificial arrangements.

Creditors, both secured and unsecured, will need to be convinced that a deed is in their interests. No doubt, they will be influenced by the financial position of the company and the asset secured, the past behaviour of directors of the company, the explanation for the problems being faced, the quality of financial information and business plans being presented, the desire to retain the company as a future client and the degree to which the creditors believe the directors, the company and associated parties are sharing the financial sacrifices associated with the compromise.

The attendance at creditors meetings under the new voluntary administration procedures will be a novel experience for the ATO, particularly as the meetings will be looking to determine the fate of a company and whether a deed of company arrangement is appropriate. We need to start looking at the commercial realities associated with such decisions and the best option available to ensure the maximum return to the revenue.

Of course our "best option" may not be the majority decision of the particular meeting and we will need to then consider whether it will be appropriate to approach the Court as an aggrieved creditor. The decision to seek the support of the Court would need to be taken in the light of what the majority of creditors decided. I do not think it would be an unreasonable expectation in some instances to have the Court rule against the ATO if our activities or opposition to a deed, for example, were to disadvantage a majority of creditors.

The changes to both the Corporations Law and the Income Tax Assessment Act mean the ATO needs to seriously consider the way it deals with debts that were previously subject to the priority. I view the changes at proactive legislation that enable us to identify and institute action to collect unremitted amounts sooner. As I indicated earlier, we are no longer required to establish actual amounts before commencing recovery action.
The fact that we now have the power to make and recover an estimate is a powerful tool in our arsenal for collecting the revenue. However, the presence of this tool does not necessarily mean that we will abandon other methods of establishing debts, like telephone and other forms of enquiry. In fact, I would envisage that in the early stages, the estimation process would be used in limited instances because of the potential accounting difficulties that may arise with the estimate, the underlying liability and directors penalties being parallel liabilities.

I think the more significant change is the one that makes directors personally liable for amounts not remitted. Personal liability automatically attaches when an amount is not remitted by the due date, but directors are not required to pay anything unless and until the Commissioner sends a penalty notice. I would (regard?) it as incumbent on the ATO to issue these types of notices once it is established a company has failed to remit. Clearly the concept of personal liability for tax debts will force directors to consider the financial position of the company and act decisively. It would not be unreasonable to expect that directors will now think twice about using the unremitted amounts to fund the operations of their companies.

We accept that the use of directors' guarantees which permit a creditor to register a caveat over directors' personal property may mean the ATO is not able to recover from directors. This is not seen as an impediment to any action the ATO may commence. It should be kept in mind that directors can avoid personal liability by exercising one of the four options available to them, that is, by payment, by entering into a payment arrangement, by placing the company into voluntary administration or by placing the company into liquidation.

I suppose if it became apparent that directors would deliberately setting out to structure the affairs of companies to defeat the provisions of the law we would look to use other enforcement tools, such as provided by section 8Y of the Taxation Administration Act (dealing with the liability of offices of corporations) and section 218 of the Crimes Act (which provides for the granting of way reparation order).

In summary, the insolvency law reforms introduced by the Government as a result of the recommendation of the Harmer Report should hasten corrective action for an insolvent corporation, whether it be company controlled or initiated or creditor controlled or initiated. There can be few loses from this process.

The fact that the ATO is now an unsecured creditor means that we need to be more proactive in dealing with those companies that do not remit to ensure the revenue is not lost and to overcome the situation of escalating debt. The fact that invariably, the ATO will be creditor and able to vote at creditors’ meetings called as part of the new voluntary administration procedures means we need to adopt a commercial approach to our decisions when deciding the fate of companies.