ATO audit hit list for business in 2014

Introduction

Every year the Commissioner releases the ATO's compliance program that sets out his views on the most significant tax compliance risk areas.

In broad terms, the Commissioner's compliance program foreshadows the ATO's audit 'hit list' for the coming year and, in this regard, is a valuable resource, particularly for taxpayers operating within industries of potential audit interest.

On 30 June 2013, the ATO released its compliance program for 2014, which, not surprisingly, shows it remains focused on the following key areas with regards to business taxpayers:

HERE (a) **Superannuation Guarantee obligations** – The ATO is concerned that many employers have failed to meet their underlying superannuation guarantee obligations. One key area where concern has arisen (and ultimately been the catalyst for a recent decision) relates to the dichotomy between the payment of an allowance versus a reimbursement and the circumstances in which the later amount may create a superannuation guarantee obligation upon the employer to their employees.

Another concerning development that has arisen with respect to superannuation guarantee relates to the ability of the ATO to recover unpaid superannuation guarantee from **company directors**.

To that end, the director penalty laws give the Commissioner unprecedented powers to recover unpaid superannuation guarantee amounts from both current and former directors of a company. In fact, there may be circumstances in which a new director may also be exposed to penalties where an underpayment of superannuation guarantee arose prior to the director being appointed to the company.

(b) **Small business benchmarks and the cash economy** – The ATO continues to increase its focus on businesses under-reporting their cash income by targeting those that operate outside the small business benchmarks for their industry.

To that end, there has been a proliferation of tax cases involving businesses operating in cash-based industries that have challenged assessment raised by the ATO relying upon industry benchmarks or an asset betterment approach.

In virtually all these cases, the taxpayer has been unable to provide evidence/information to disprove that the Commissioner's assessment of their tax affairs was excessive. This has meant that the large audit adjustments raised by the ATO have been upheld and the taxpayer has been liable for both the underlying tax liability and the penalties raised by the ATO (being the culpability penalty and shortfall interest charge).

In this segment of the seminar notes we will examine some of the ATO's audit targets for the 2014 income year under the following broad headings:

HERE Pages attached

1. **New super guarantee laws create tax minefield for current and former directors** (Refer to pages 92 to 107).
2. **Full Federal Court confirms audit adjustment using asset betterment method** (Refer to pages 108 to 111);
3. **AAT accepts use of industry benchmarks for a taxpayer with poor records** (Refer to pages 112 to 116); and

Please note that all section references are to the Income Tax Assessment Act 1936 unless otherwise denoted.

1. New super guarantee laws create tax minefield for current and former directors

An important and often overlooked area of the law that can potentially result in a company director (including a director of a corporate trustee) becoming **personally liable** for certain employee-related company debts is the **director penalty regime** ('DPR') contained in Division 269 of the *Taxation Administration Act 1953* ('TAA').

By way of background, the broad purpose of the DPR is to ensure that directors cause their companies to meet certain employee-related obligations, including the obligation to remit **PAYG withholding** ('PAYGW') to the ATO (e.g., in respect of payments of salary). The DPR further seeks to ensure that, if a company is unable to fund these employee-related obligations within a specified period, the director promptly places the company into liquidation or administration.

However, whilst many directors are aware of the existence of the DPR generally, some may not be aware that the law has recently been amended to **strengthen** and **expand** the DPR.

TAX WARNING – DPR changes increase personal liability risk

In particular, directors should be aware of the following changes recently made to the DPR:

(a) Traditionally, directors only faced potential personal liability under the DPR where a company of which they were a director failed to remit employee PAYGW to the ATO.

However, as a result of recent amendments to the law, which took effect from **30 June 2012**, the scope of the DPR has been *extended* to now also cover any outstanding **superannuation guarantee charge** ('SGC') imposed under the *Superannuation Guarantee Administration Act* ('SGAA').

(b) Furthermore, directors were once able to avoid personal liability under the DPR simply by placing their company into **administration** or **liquidation** at any time prior to a **Director Penalty Notice** ('DPN') being issued, or within a '21-day DPN period'. However, as a result of recent changes, the ability of a director to avoid personal liability in this way has been *removed* in circumstances where the company's PAYGW and/or SGC remains **unpaid and unreported 3 months** after the relevant 'due date'.

These *'lockdown director penalty'* provisions also apply from **30 June 2012**.

It is important for advisers and directors to be aware that this area of the law is currently on the ATO's **'hit list'**. Specifically, the ATO has begun making use of its recently expanded powers under the DPR (e.g., to pursue unpaid SGC) and are 'cracking down' on the directors of non-complying companies. In fact, over the past few months, compliance activity has begun in earnest with the ATO sending **'warning letters'** to directors of companies with unpaid SGC obligations (in the past, such letters were only sent with respect to unpaid PAYGW obligations).

If a director receives a 'warning letter', the director must take ***immediate action*** to avoid personal liability under the DPR in relation to the unpaid SGC. To assist in this regard, this section of the notes provides an overview of the DPR **in the context of unpaid SGC**, including how the DPR applies to **past, present** and **future** directors, before highlighting strategies and defences that are potentially available to directors to **avoid personal liability** for unpaid SGC under the DPR. The issues identified above will be discussed under the following broad headings:

1.1 An overview of the DPR;

1.2 Strategies and defences to avoid personal liability under the DPR; and

1.3 NTAA checklist – Minimising risk of personal liability under the DPR.

Please note that references in this section of the notes are to the TAA, unless otherwise stated.

1.1 An overview of the director penalty regime

This section of the notes provides a broad **overview** of the DPR in the context of **unpaid SGC**, including when a past, present or future director will be **personally liable** for unpaid SGC in respect of a particular quarter, the **penalty amount** and when it becomes **due and payable**.

The following section of the notes then considers some **strategies** that can be considered by directors to assist in avoiding potential liability arising under the DPR, including the circumstances in which a penalty may be **remitted**, or in which a **statutory defence** is available.

TAX TIP – Special concessional rules available for 'new' directors

It is important to be aware that there are some special concessional 'rules' that apply to **'new' directors**. These rules affect the time at which a new director can be made personally liable for a director penalty, and also the circumstances in which a new director is able to have a director penalty remitted. These concessional rules are discussed in detail below.

As noted, the purpose of this section of the notes is to provide an overview of the DPR in the context of unpaid **SGC** obligations. It is important to be aware that, whilst the notes focus on outstanding SGC, these 'rules' apply in a similar fashion to unpaid PAYGW obligations.

1.1.1 When is a director personally liable for SGC under the director penalty regime?

As a starting point, S.269-10 to S.269-20 interact to broadly provide that the directors of a company must **cause the company** to meet its obligations to pay any outstanding SGC by the end of the relevant **'due day'** (as defined) and that, if the company fails to do so, the **directors** are prima facie liable to pay the ATO a penalty equal to the unpaid amount (subject to the penalty being remitted or the director satisfying a specified defence – refer below).

A director will be 'caught' under the DPR broadly where they were a director *at any time* during the period **beginning** when the company's liability 'accrues' (referred to as the 'initial day', a day that is defined in the legislation – refer below) and **ending** on the 'due day'. More specifically, for **SGC** purposes, a director is potentially liable under the DPR where *both* the following apply:

(a) The company has **not** met its super guarantee ('SG') obligations under the SGAA by the 'due day' (refer (b) below). This obligation can be met either by paying the requisite SG amount into the employee's superannuation fund by the 28th day of the **1st month** following the end of the relevant quarter **or**, if not paid by that date, by paying the requisite (non-deductible) SGC amount (which includes the SG amount plus a nominal interest and administration charge) to the ATO by the 28th day of the **2nd month** following the end of the quarter.

In certain circumstances, an employer may be able to claim a **'late payment offset'** to reduce their SGC liability where a late superannuation contribution was paid into a superannuation fund (rather than to the ATO as required) – refer to S.23A of the SGAA.

(b) The director was a director of the company *at any time* during a period which starts from the 'initial day', being the last day of a SG quarter (i.e., 31 March, 30 June, 30 September or 31 December), and ends on the relevant 'due day'. The 'due day' for these purposes is the date by which the company must lodge an SGC statement under S.33 of the SGAA, which is the 28th day of the **2nd month** following the end of the quarter – refer to S.269-10(3).

TAX TIP – Directors exposed under the DPR from June 2012 quarter

The DPR only applies to obligations under the SGAA from **30 June 2012** and, as such, directors are only exposed to penalties under the DPR where the unpaid SGC relates to the **June 2012 (or a later) quarter** (i.e., where the 'initial day' is 30 June 2012 or later).

In addition to the above, also be aware that a special provision applies to 'new' directors which ensures that even a **'new' director**, appointed **after** the 'due day' in respect of an outstanding SGC liability, will be subject to penalty under the DPR in respect of that liability where they remain a director for **at least 30 days** (and the liability remains unpaid). Refer to S.269-20(3).

The following section of the notes considers the above rules in the context of an **existing** director, a **retiring** director (e.g., a director that retires before the 'due day') and a **'new'** director.

A. 'Existing' directors can be personally liable under the DPR

Based on the rules set out above, it is clear that a person who is an 'existing director' of a company (e.g., a person was a director throughout the period when the SG obligation accrued through to when an SGC liability is due for payment) will be subject to penalty under the DPR for unpaid SGC owing in respect of that quarter, as illustrated in the following example.

EXAMPLE 1 – 'Existing' director liable for unpaid SGC under the DPR

Due to financial difficulty, XYZ Pty Ltd was unable to pay its SGC liability in respect of the 30 June 2014 quarter, which was due for payment on 28 August 2014 (based on these facts, the **'initial day'** is 30 June 2014 and the **'due day'** is 28 August 2014).

Maggie is currently a director of XYZ Pty Ltd and has been since its inception in 2005.

In these circumstances, it is clear that Maggie can be made personally liable for the unpaid SGC under the DPR. The amount of the penalty, and the way in which the ATO is required to commence recovery proceedings in respect of the penalty, is discussed below.

B. Dealing with former directors – can a director simply resign to avoid personal liability under the DPR?

As noted above, it is clear that a person who is a director of a company during the period an SGC liability accrues through to when the liability is due and payable is prima facie caught under the DPR in circumstances where the company has an outstanding SGC liability.

However, based on S.269-10 to S.269-20, a person who is a director of a company at the end of an SG quarter (the 'initial day') is also prima facie subject to penalty under the DPR for unpaid SGC owing in respect of that quarter **even if the director retires as a director**, whether that retirement happens prior to, or after, the 'due day' (i.e., even if the director is a **'former director'**).

As a result, once the last day of a SG quarter has passed, it is **not** possible for a director to avoid personal liability under the DPR for unpaid SGC owing in respect of that quarter simply by resigning, even if the director resigns prior to the 'due day'. Such a resignation can **only** be effective if it occurs *prior to* the 'initial day' (i.e., *prior to* the last day of the relevant SG quarter).

EXAMPLE 2 – 'Former' director liable for unpaid SGC under the DPR

Due to financial difficulty, ABC Pty Ltd was unable to pay its SGC liability in respect of the 31 March 2014 quarter, which was due for payment on 28 May 2014 (based on these facts, the **'initial day'** is 31 March 2014 and the **'due day'** is 28 May 2014).

Valerie was a director of ABC Pty Ltd at the end of the March 2014 quarter (i.e., on 31 March 2014), however, after becoming aware of the full extent of financial difficulties ABC Pty Ltd faced, Valerie resigned from the position of company director on 1 May 2014.

In these circumstances, Valerie **is** still prima facie personally liable for the unpaid SGC owing in respect of the March 2014 quarter because she was a company director on 31 March 2014 (the 'initial day'). Importantly, this is the case notwithstanding Valerie resigned from her position as a director of the company *prior to* 28 May 2014 (i.e., prior to the 'due day').

C. When is a 'new' director personally liable under the DPR?

Section 269-20(3) provides that even a **'new' director** who is appointed **after** the 'due day' of an SGC liability will be subject to penalty under the DPR in respect of that liability **where they remain a director for at least 30 days** (and the liability remains unpaid).

TAX TIP – The 30-day 'grace period' for 'new' directors

The legislation provides a **30-day 'grace period'** for 'new' directors to allow them time to ensure that the affairs (including SGC affairs) of the company are in order before the director can be made personally liable for a director penalty under the DPR, including in respect of SGC obligations that remain unpaid from **before** they were appointed.

If a 'new' director cannot be satisfied that the company's outstanding liabilities for SGC have been paid, the person may consider not accepting appointment as director or, if they have already done so, may consider resigning from the position (within 30 days of being appointed a director) to avoid personal liability arising under the DPR in respect of these debts.

The 'grace period' was increased from 14 days to 30 days with effect from 30 June 2012 (presumably this was done to allow further time for 'new' directors to deal with the SGC).

Section 269-20(4) then provides that, if the 'new' director remains a director at the end of the 30-day 'grace period', they are **personally liable** for a penalty in respect of outstanding SGC. That penalty is (prima facie) due and payable at the **end of that 30th day**.

In contrast to this, a 'new' director that is appointed **on or before** the 'due day' is subject to a director penalty under the DPR in respect of that liability (if it remains unpaid) under S.269-20(1) as are other directors (so **the 30-day grace period is *not* available**).

As a result, it is vital that new directors use the 30-day 'grace period' provided for in the law to undertake a **thorough due diligence** to identify potential exposure under the DPR (assuming this was not done prior to accepting the appointment). Overlooking this process may result in the new director becoming **personally liable** for SGC, even if that liability accrued and/or became payable **prior to the person being made director**.

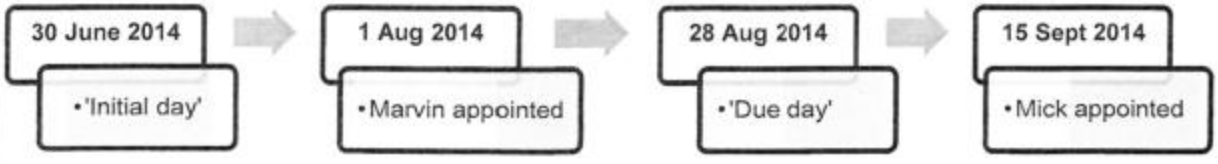
Of course, if a 'new' director does become aware that they have exposure under the DPR, they should immediately consider their options regarding **remission** of the director penalty, and also consider whether they are able to access a **defence** to prevent recovery of the director penalty.

In this regard, whilst there are special (concessional) rules for 'new' directors that make the possibility of remission slightly more generous (than is the case for existing directors), these options are still quite **limited**, as discussed below.

EXAMPLE 3 – 'New' director becomes personally liable for SGC

Murphy Pty Ltd ('Murphy') has an outstanding SGC liability which accrued in respect of the SG quarter ended 30 June 2014. On 1 August 2014, **Marvin** was appointed as a director of the company and on 15 September 2014 **Mick** was appointed as a director of the company.

The above series of events can be represented as follows:



The following consequences arise under the DPR for **Marvin** and **Mick**:

- **Marvin** is liable to pay a director penalty under S.269-20(1) on the 'due day' (assuming the liability remains unpaid). Note, because Marvin became a director *prior to* the 'due day' he is **not** entitled to the 30-day 'grace period' under S.269-20(3). In this case, Marvin should consider his options for remission and/or statutory defence (refer below).
- As **Mick** was appointed as a director *after* the 'due day', he is entitled to a 30-day 'grace period' within which to investigate his potential liability under the DPR.

  There are **no** consequences for Mick if he chooses to **resign** before the end of the 'grace period' (e.g., he may do this if the company has not paid the SGC liability by this time).

  However, if Mick remains a director beyond the 30-day 'grace period', he will become **personally liable** for the SGC liability at the end of that 30th day (assuming it remains unpaid). In this case, Mick should consider his options for remission and/or statutory defence as discussed below.

D. Can the DPR apply to a 'deemed director'?

The mere fact a person is not formally appointed to the position of director (such a person is often referred to as a **'shadow director'**) does **not** prevent them from being treated as a director under Division 269 for the purposes of the DPR.

More specifically, S.9 of the *Corporations Act 2001* (CA) provides that a director of a company means *"a person who is appointed to the position of a director... regardless of the name that is given to their position."* However, this provision further provides that a director also means:

> *"...unless the contrary intention appears, a person who is **not** validly appointed as a director if (i) they act in the position of a director; or (ii) the directors of the company...are accustomed to act in accordance with the person's instructions or wishes."*

The risk that a person may be a 'shadow director' has particular relevance in the context of single director companies where the director's spouse may be the 'controlling mind' of the company.

TAX TIP – Advisors are generally *not* taken to be deemed directors

The CA (and TAA) makes a distinction between an advisor and a (deemed) director, which means that, in most cases, an advisor will **not** be taken to be a deemed director.

Specifically, S.9 of the CA broadly provides that a person will not be a deemed director:

*"...merely because the directors **act on advice given by the person in the proper performance of functions attaching to the person's professional capacity**, or the person's business relationship with the directors or the company or body."*

In other words, this means that a person will *not* be a director merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors.

However, it is recommended that professional advisors take certain action to avoid 'overstepping the mark' in this regard, including (for example) using an **engagement letter** to define the terms of an engagement, and ensuring that only **advice** or **guidance** is provided to assist directors in making decisions regarding a company (i.e., rather than *instructions*).

1.1.2 What is the amount of the penalty under the DPR?

Pursuant to S.269-20(5), the **amount of the penalty** imposed on a director liable under the DPR in respect of unpaid SGC is equal to the unpaid amount of the company's SGC (there are special provisions which permit the ATO to **estimate** a company's SGC liability for this purpose – refer to Division 268). Further note that, whilst the directors are collectively under an obligation to ensure the company pays its SGC, the director penalty applies to each of them **individually**. Accordingly, each director can be pursued by the ATO for the same penalty under the DPR.

However, in this regard note that the collective liabilities operate on a parallel basis. That is, there is, in effect, **only one debt**. For example, if Director 'A' and Director 'B' each have a $50,000 penalty under the DPR and Director 'A' pays $20,000, the liability in relation to each DPN automatically drops to $30,000 (as does the company's liability). Refer to S.269-40.

TAX TIP – Directors right to seek recovery from other directors

If a director pays an amount of penalty, they are taken to have the same rights (whether by way of indemnity, subrogation, contribution or otherwise) against the company or anyone else as if they had made that payment under a guarantee.

Of course, any rights against the company will generally be worthless as it is often **insolvent**. However, if the ATO issue a DPN to 5 directors and only one director ends up paying the entire penalty, that director may potentially have a right to seek recovery from the other directors. Refer to S.269-45.

1.1.3 When does the penalty become due and payable?

The penalty is due and payable on the 'due day' (i.e., broadly the day the SGC was required to be paid). However, whilst a director may have become liable for a penalty, there is a strict procedure the ATO must observe before they can commence **recovery proceedings** (note that the penalty can ultimately be recovered in many ways, such as by garnisheeing bank accounts, offsetting refunds or by court action). Refer S.269-20(2).

Specifically, the Commissioner must issue a DPN and wait until **21 days after the issue of that notice** to commence recovery proceedings.

The ATO can post the DPN to, or leave the DPN at, the director's address as listed with **ASIC**. The notice is taken to be issued from the date posted or left and, therefore, the 21 day period starts 'ticking' from this date (**not** when the notice is **received**). Refer S.269-50 and S.269-25(4).

TAX TIP – Providing a copy of DPN to director's registered tax agent

Further to the above note that, under S.269-52, the Commissioner is able to provide a copy of the DPN to the director's **registered tax agent**. However, this of itself will not constitute giving effective notice for the purposes of the DPR (i.e., to be effective, the DPN must broadly be left at, or posted to, the director's address as listed with ASIC, as stated above).

Of course, as indicated earlier, there are various courses of action that a director can consider in order to avoid personal liability under the DPR and, if any such action is successful, any amount otherwise (prima facie) due and payable under the DPR will **not** be due and payable.

Such action includes causing the company to pay the outstanding SGC or, in certain circumstances, placing the company into **administration** or **liquidation**. There are also various **statutory defences** potentially available to directors to avoid personal liability under the DPR.

These important **strategies** and **defences** are discussed in the following section.

1.2 Strategies and defences to avoid personal liability under the director penalty regime

The above section of the notes identified *when* a company director (including the director of a corporate trustee) may potentially be **personally liable** for an unpaid SGC liability of the company of which they are (or were) director. Having established that a director may be exposed to personal liability, it is important to consider whether any strategies or defences are available to the director to *legally* mitigate, or avoid, any personal liability.

TAX TIP – Simple but effective strategy to avoid liability under DPR

It is important to note that, whilst the DPR has certainly become more onerous as a result of the recent amendments discussed above, a simple 'strategy' to ensure a director will **not** be subject to personal liability under the DPR in respect of unpaid SGC is for the director to always ensure that any company of which they are a director adheres to its SG obligations **by always making the correct payment on time**.

Of course, there will be times when a company does **not** comply with their obligations under the SGAA, and this could be for many reasons, including that the company is facing financial difficulties, or due to error or oversight (e.g., an employer may incorrectly classify an individual worker as an independent contractor rather than an employee – refer below).

Fortunately, there are various strategies and defences that may be available to a director in order to avoid any personal liability arising under the DPR in these circumstances, as discussed below.

TAX TIP – Robust asset protection plan recommended for directors

Directors should keep potential exposure under the DPR in mind when devising an **asset protection strategy** for themselves and their family. For example, a director of a trading company (or director of a corporate trustee of a trading trust) should avoid accumulating private assets and investments in their name (wherever possible) due to the risk that they may be exposed to significant personal liabilities associated with the directorship of the company. Also, an asset-rich individual considering taking up a directorship should be aware of the possibility of the DPR imposing personal liability on them.

Of course, asset protection plans are more likely to be **effective** where implemented prior to a risk actually crystallising (e.g., prior to a company experiencing financial difficulty).

1.2.1 Avoiding liability by resigning as director

One strategy a director can consider in order to reduce exposure to personal liability under the DPR is simply to **resign** as a director. However, whilst such a strategy seems appealing, it is important to be aware of the following issues which may limit the effectiveness of this strategy:

(a) If a person is a director of a company on the last day of a SG quarter in respect of which an unpaid SGC liability has arisen, it is **not** possible for the director to simply retire in order to avoid personal liability in relation to that liability, as illustrated above. However, that person will potentially avoid personal liability in respect of any **future SG quarters**.

For instance, a director can avoid liability in respect of an unpaid SGC liability arising for the March 2014 quarter if they retire *prior to* 31 March 2014 but not if they retire on that date or at any time after this (i.e., even if they retire prior to 28 May 2014, being the 'due day').

(b) Even after retiring as director, there is a risk that the person could be considered a 'deemed director' or 'shadow director' where the person continues to act in the position of a director, or if the continuing directors of the company are accustomed to act in accordance with the person's wishes or instructions. Refer to the discussion above.

1.2.2 Remission of penalty where company is liquidated or an administrator is appointed to the company

The Commissioner cannot commence recovery proceedings in respect of a director's penalty until **21 days after** notice of the penalty (i.e., the DPN) is given to the director. Refer S.269-25.

Further to this, S.269-30(1) broadly provides that, subject to **one important exception** (refer below), a director's penalty arising under the DPR is **remitted** (thus allowing the director to avoid **personal** exposure) if, before a DPN is issued, or **within 21 days** after the issue of a DPN, any of the following occur:

(a) The company **pays the liability**;

(b) An **administrator** of the company is appointed; or

(c) The company begins to be wound-up (i.e., **liquidated**).

EXAMPLE 4 – Director has director penalty remitted

DEF Pty Ltd has outstanding SGC liabilities in respect of the December 2013 and March 2014 SG quarters. The company could not pay the liabilities but the liabilities were reported to the ATO as required via an SGC Statement (which was lodged by the due date). In these circumstances, the company directors are nonetheless prima facie personally liable, via a director penalty under the DPR, for the outstanding SGC liability. As it transpired, the ATO issued the directors with a DPN in this regard.

In light of the company's serious financial troubles, within 21 days after notice of the penalty was given (i.e., the DPN), the directors appointed a **liquidator** to the company. As a result of this action, S.269-30 provides that the director penalty is **remitted**, which basically means that the directors *cease* to be personally liable for the unpaid SGC liability.

The important ***exception*** to the remission referred to above applies where the director triggers the **'lockdown director penalties'**. Specifically, if the 'lockdown director penalties' are triggered, the director *loses the ability* to have any director penalty imposed under the DPR remitted even if they appoint an administrator or a liquidator, as explained below.

A. The 'lockdown director penalties' exception

From the outset, it is important to be aware that the 'lockdown director penalties' were introduced as part of the recent amendments to the DPR and **take effect from 30 June 2012**.

Further, the 'lockdown director penalties' exception applies slightly differently depending on whether the director in question is an **existing** director (i.e., a person who was a director at any time between the 'initial day' and the 'due day') or a **'new'** director (i.e., a person appointed as director *after* the 'due day' of the SGC liability in respect of which the penalty relates).

(i) Applying the 'lockdown director penalties' to existing directors

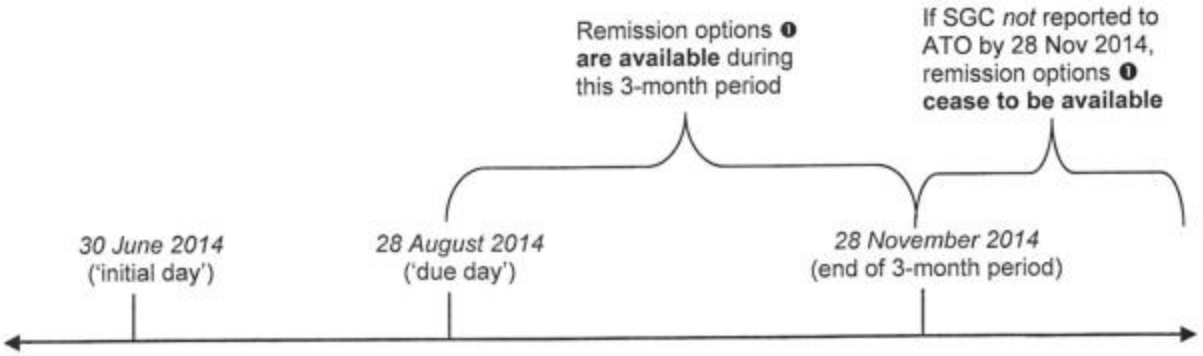
The **'lockdown director penalties'** will apply where, from 30 June 2012, the SGC remains **unreported** to the ATO (on the 'SGC statement') **for more than 3 months after the 'due day'**.

By way of background, prior to the introduction of the 'lockdown director penalties' directors were able to avoid personal liability under the DPR simply by placing their company into **administration** or **liquidation** at any time prior to a DPN being issued, or within 21 days of the DPN being given (i.e., the '21 day DPN period'). Importantly, this relief was available regardless of whether or not the company had ***reported*** the unpaid liability to the ATO.

The 'lockdown director penalties' were introduced (with effect from 30 June 2012) to basically encourage company directors to cause their companies to **report** outstanding SGC (and PAYGW) liabilities to the ATO on a timely basis. Refer S.269-30(2).

The 'lockdown director penalties' achieve this by ensuring that directors **remain liable** for a director penalty, even if there is an appointment of an administrator or a liquidator (within the '21 day DPN period'), where the appointment occurs outside a **3-month period** (that is, a 3-month period from the 'due day') during which the company's liability remains unpaid ***and unreported***.

For example, where a director penalty arose in respect of the SG quarter ended 30 June 2014, the directors of the company would lose the ability to have the penalty remitted (i.e., by appointing an administrator or liquidator within the 21-day DPN period) if the SGC liability has not been **reported** to the ATO by **28 November 2014** (being the date that is 3 months after the 'due day' of that liability). This can be represented as follows (assume the SGC liability remains *unpaid)*:



❶ *'Remission options' broadly refers to remission under S.269-30 due to the appointment of an administrator or a liquidator, as discussed above.*

The introduction of the 'lockdown director penalties' has obviously created a **huge risk** for company directors as, if a director receives a DPN at a time when the 3 month period has elapsed (without the amounts having been reported to the ATO), all the ATO is really doing is advising the director that they (or the company) have 21 days to **pay** or they will commence **recovery proceedings** (unless a statutory defence is otherwise available – refer below).

EXAMPLE 5 – Director caught by 'lockdown director penalties'

ABC Pty Ltd has an outstanding SGC liability in respect of the 31 March 2014 SG quarter. The company has *not* **paid** this amount and has **also failed to report** this amount to the ATO within 3 months of 28 May 2014, being the 'due day' (or in fact at **any** time). As a result of the SGC liability, a 'director penalty' arises for the company directors under S.269-20.

The ATO issue a DPN to the directors in November 2014 (i.e., more than 3 months after the 'due day'). Upon receipt of the DPN, as the company is unable to pay the SGC liability, the company directors seek to **avoid personal liability** under the DPR in respect of the unpaid SGC by appointing an administrator to the company. Refer to S.269-30 and above.

In these circumstances, the directors actions will *not* be effective in avoiding personal liability, even though the administrator was appointed within 21 days of the ATO giving the DPN.

Rather, the directors will **continue to be personally liable** for the unpaid SGC because, by not reporting the SGC liability within the 3-month period (from the 'due day'), the 'lockdown director penalties' were invoked. This means that the directors lose the ability to have the director penalty remitted by appointing an administrator, or liquidator, to the company.

Importantly, had the company **reported** the outstanding SGC liability as required (within the requisite 3-month period), the appointment of the administrator in the above circumstances would have achieved an **effective remission** of the director penalty.

Whilst the introduction of the 'lockdown director penalties' has undoubtedly created a new risk for directors, it is important for directors to be aware of the following simple 'strategy' that can be employed to ensure the 'lockdown director penalties' are **never** triggered in respect of unpaid SGC: **ensure the company *reports* SGC liabilities *on a timely basis***, as discussed below.

(ii) Applying the 'lockdown director penalties' to 'new' directors

As stated above, **existing directors** lose the right to appoint an administrator or liquidator and thereby avoid personal liability in respect of unpaid SGC if the company has failed to report the SGC liability to the ATO within a 3-month period ***commencing on the 'due day'***. It is important to be aware that this rule is **modified** for **'new' directors** under S.269-30(3).

Specifically, S.269-30(3) provides that, if a person becomes a director *after the 'due day'*, the 3-month period is not measured from the 'due day' but, rather, **from the time they became a director** (this modification applies regardless of how long the company has been liable for the outstanding SGC). In effect, this gives 'new' directors additional time in which to ensure the company reports its SGC obligations to the ATO before the 'new' director loses the right to have the director penalty remitted via the appointment of an administrator or liquidator.

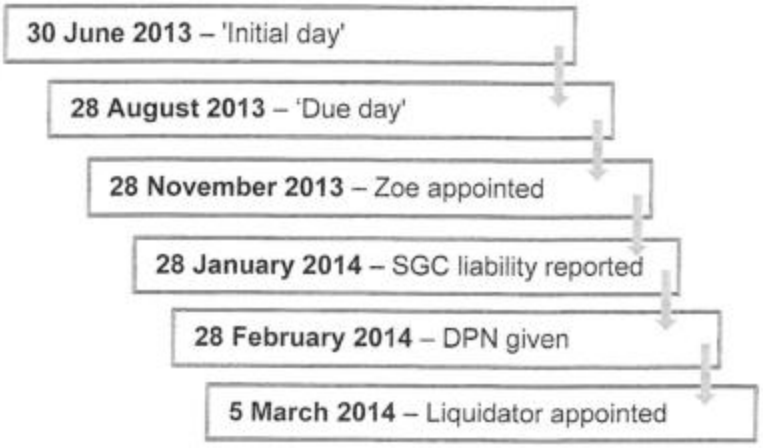
Notably, this 'modified' 3-month period used to determine if the 'lockdown director penalties' have been triggered for a 'new' director does **not** alter the requirement for the administrator or liquidator to be appointed within **21 days** of the ATO giving a DPN to the 'new' director in order for the 'new' director to obtain remission of the penalty under S.269-30(1).

EXAMPLE 6 – 'Lockdown director penalties' for a 'new' director

Britt Pty Ltd has an outstanding SGC liability which accrued in respect of the SG quarter ended 30 June 2013. On 28 November 2013, Zoe was **appointed** as a director of the company. Zoe reviewed the corporate affairs over the subsequent months and discovered the unpaid SGC liability. As a result of this review, the company **reported** the outstanding liability to the ATO on 28 January 2014 (the liability remained unpaid).

As it transpired, the ATO issued a **DPN** to each of the company directors, including Zoe, on 28 February 2014. Within the week (i.e., 5 March 2014), the directors **appointed a liquidator**, hoping to avoid personal liability under the DPR in respect of unpaid SGC.

The above series of events can be represented as follows:



The following consequences arise under the DPR for **Zoe**:

- As Zoe was appointed as a director *after* the 'due day', she is entitled to a 30-day 'grace period' within which to investigate her potential liability under the DPR. As Zoe remained a director beyond the 30-day 'grace period', she became **personally liable** for the SGC liability at the end of that 30th day (since the SGC liability remained unpaid).
- As Zoe was appointed as a director *after* the 'due day' (i.e., she is a 'new' director) *and* the outstanding SGC liability was reported to the ATO within 3 months of Zoe being appointed as a director (the liability was reported within 2 months of Zoe being appointed), the 'lockdown director penalties' have *not* been triggered from Zoe's perspective.

- Furthermore, because the 'lockdown director penalties' were *not* triggered and a liquidator was appointed within **21 days** of the ATO giving the DPN (i.e., the liquidator was appointed on 5 March 2014, 5 days after the DPN was given), Zoe's director penalty is **remitted** which means she is *not* personally liable under the DPR.

For completeness, note that, just because Zoe, a 'new' director, avoided personal liability under the DPR does not necessarily mean that an ***existing*** director will also avoid liability.

In fact, based on the scenario above, an existing director (e.g., a person who was a director on 28 August 2013, being the 'due day'), **would** be personally liable for the SGC liability for the June 2013 quarter. This is because, from the perspective of an existing director, the 'lockdown director penalties' *have been* triggered, as the SGC liability was not reported within 3 months of the **'due day'** (i.e., it was reported after 5 months). As a consequence of this, the existing director is *not* permitted to have their director penalty remitted under S.269-30 (even though a liquidator was appointed within 21 days of the DPN being given).

However, based on the timing of the events above, appointing a liquidator **will** ensure that (all) directors are able to avoid personal liability on any unpaid SGC liabilities arising in **subsequent quarters** (e.g., the September 2013 quarter or the December 2013 quarter).

(iii) Avoid the 'lockdown director penalties' simply by REPORTING!

As is evident above, the 'lockdown director penalties' exception creates a huge risk for all directors, **past, present and future**, who are liable to a director penalty under the DPR.

For this reason, it is important that directors ensure that, regardless of whether a company makes the correct SGC (or PAYGW) payments on time, the company **reports on time**, or at least within the relevant 3-month period (e.g., by lodging SGC Statements). By doing this, the director is able to avoid the 'lockdown director penalties', thus ensuring the director maintains the ability to avoid personal exposure under the DPR by appointing a liquidator or administrator to the company.

It is important to be aware that any attempt to 'delay the inevitable' by *not* lodging an SGC Statement (i.e., and, thus, not reporting the liability amount to the ATO) is **fraught with danger**.

TAX WARNING – Attempts to delay the inevitable by not reporting

In the past (i.e., before the DPR applied to the SGC) it was possible to effectively delay a SGC liability simply by not lodging a SGC statement. This was because, under the SGAA, the SGC is *not* payable until the ATO makes an assessment of the SGC. However, despite this, S.269-10(3) ensures that, for the purposes of the DPR, the company's SGC:

> *"is treated as being payable on the day by which the company must lodge a superannuation guarantee statement for the quarter [the 'due day']...**even if the charge is not assessed under that Act on or before that day." [Emphasis added]***

The implications of this are twofold: first, it means that a director is prima facie personally liable for unpaid SGC as at the 'due day' (i.e., as described above) and, secondly, it means that the 'lockdown director penalties' will be triggered if the company does not report the SGC liability within 3 months of the 'due day'.

Furthermore, the provisions ensure that lodging a SGC Statement which **underestimates** the company's SGC liability will also be counterproductive. In these circumstances, *to the extent of the understatement* the 'lockdown director penalties' will be triggered (assuming the correct liability is not subsequently reported within the 3-month period). Refer to item 3(a) in Column 3 of the table in S.269-30(2).

The above DPR provisions are complemented by the recent expansion of the provisions which allow the ATO to make an **estimate** of a company's SGC (and PAYGW) liability. Refer S.268-10.

TAX WARNING – Preference payments to the ATO can backfire

If the directors know the company is in financial difficulty but want to avoid personal liability for SGC or PAYGW (e.g., outside the 'lock-down director penalties' period), it is important to be aware that paying the ATO in preference to other creditors **may be counterproductive**.

This is because, if the company is wound-up, the liquidator may seek to recover the payment as a **'voidable preference payment'** made while the company was insolvent under S.588FA and S.588FC of the CA (i.e., if successful this means the ATO must repay the amount to the liquidator), in which case, the ATO becomes entitled to indemnity from the directors for the amount repaid (thus, the director becomes personally liable in any case). Refer S.588FGA.

1.2.3 Entering into a payment arrangement with the ATO

Prior to liquidating a company or appointing an administrator in order to have a director penalty amount remitted (assuming such remission is possible – refer above), it may be appropriate to consider entering into a **payment arrangement** with the ATO in relation to the liability.

A director can **defer** the commencement of recovery proceedings under the DPR where the company enters into a **payment arrangement** pursuant to S.255-15 in relation to the company's unpaid SGC liability. Specifically, S.269-15(3) provides that the ATO must not commence, or take a procedural step as a party to, proceedings to enforce an obligation, or to recover a penalty, if a payment arrangement is in force under S.255-15 in relation to the company's liability.

However, before doing so, it is important to be aware of the **dangers** created by the interaction between the 'remission' and the 'payment arrangement' provisions. Specifically, whilst the ATO is prohibited from commencing recovery proceedings when a payment arrangement is in force, the ATO is **not** prevented from giving a DPN. Refer to Note 2 to S.269-15. This can potentially be significant because, if a DPN *is* issued whilst a payment arrangement is in force it can make it difficult for the director(s) to take action to have the penalty amount under the DPN **remitted**.

For instance, as noted above, one way in which a penalty amount arising under the DPR can be remitted is if the company commences to be wound-up, or an administrator is appointed, **within 21 days of the ATO giving the DPN**. Unfortunately, this 21 day period does *not* alter regardless of whether the company has already secured a deferred payment arrangement.

This basically means that, if a DPN is issued and the company defaults on its payment arrangement outside the 21 day 'window' (assuming this option is available – refer above regarding the 'lockdown director penalties'), the director will be personally liable for the debt (unless a 'statutory defence' is available) and the ATO can commence recovery proceedings.

1.2.4 Statutory defences available to directors

In addition to the above, there are basically three **statutory defences** available to directors to avoid personal liability under the DPR: the 'illness or other good reason' defence, the 'all reasonable steps' defence and the 'reasonably arguable position in relation to SGC' defence.

These statutory defences are contained in S.269-35 and are briefly described below.

However, prior to considering these statutory defences, it is important to note that, following amendments to the law which took effect from 30 June 2012, S.269-35 imposes a **60-day period** in which to raise a defence against the recovery of director penalties (whether related to SGC or PAYGW) by methods **other than court proceedings**. The 60-day period generally commences from when the ATO provides a notice that the penalty amount is to be collected from a third party (e.g., under a Garnishee Notice). For example, the 60-day limit would apply where the director wished to prevent the ATO from issuing a Garnishee Notice to a third party under S.260-5 TAA.

TAX WARNING – No relief for a director who 'acted honestly'

It will become evident below that the statutory defences available to directors to avoid personal liability under the DPR are **quite limited**; the defences are narrowly drafted and are subject to a restrictive 60-day time limit (for non-court related matters as stated above).

This is compounded by the fact there is no defence available to directors who 'act honestly'. That is, even if a director did not actively participate in actions that led to the company not paying its SGC, or did, but acted honestly in doing so (e.g., non-compliance was due to an inadvertent oversight), the director will still generally be liable for a director penalty.

To this end, note that S.269-35(5) specifically provides that S.1318 of the CA (which, among other things, gives a court power to relieve a director from liability with respect to certain claims if the person acted honestly) does **not** apply to the DPR.

A. The 'illness or some other good reason' defence

Pursuant to S.269-35(1), a person is not liable to a penalty under the DPR if, because of **illness or for some other good reason**, it would have been unreasonable to expect the person to take part in the management of the company, and the person did not take part, at any time when:

(a) The person was a director of the company; and

(b) The directors were under the relevant obligations (e.g., for the June 2014 quarter, the directors are under an obligation to pay SG from the last day ('initial day') of the quarter).

TAX WARNING – The 'illness or some other good reason' defence

It is clear that S.269-35(1) requires the illness or other good reason be present *continuously* throughout the relevant period and that, on an objective assessment, it would have been unreasonable to expect the person to take part in the management of the company during this period because of that illness (or other good reason). The director must also, as a question of fact, not have participated in the management of the company during this period. For reasons set out below, it may be difficult for directors to successfully apply this defence.

There have been a number of cases that considered this defence (albeit under former S.222AOJ of the ITAA 1936, which had slight differences in drafting) and, based on these decisions, it is clear that reliance on this defence to avoid personal liability under the DPR will be challenging.

For example, *FCT v Dick* [2007] NSWCA 190, the Court held that, whilst it was evident that a non-executive director of a football club who had no involvement in the management or financial administration of the club did not participate in the management of the club, it could not be said that he failed to do so for good reason; non-participation per se did not qualify as 'some other good reason'. Similarly, in *FCT v Robertson* [2009] NSWSC 597, a director's mistaken belief that they had resigned as a director also did not qualify as 'some other good reason', nor did the director's claim in *Kocic v DCT [2011] NSWCA 322* that he was unaware that he was a director.

B. The 'took all reasonable steps' defence

Under S.269-35(2) and (3), a person is not liable to a director penalty under the DPR if the person **took all reasonable steps** to ensure that the directors caused the company to comply with its obligations (e.g., SGC) or appoint an administrator or liquidator (or there were no reasonable steps that could have taken to ensure these things happened). In determining what 'reasonable steps' are, regard must be had to when, and for how long, the person was a director and took part in the management of the company and all other relevant circumstances.

There are a number of decisions that may assist in understanding how this defence applies (again, these cases relate to the similarly worded former S.222AOJ of the ITAA 1936).

In *Fitzgerald v FCT 95 ATC 4587* a director of only 17 days argued that he was not aware of the relevant liability until he ceased being a director and was not in a position to take reasonable steps to ensure payment (thus there were no reasonable steps that could have taken).

The argument failed, with the Court noting that the fact the taxpayer was not aware of the existence of the tax debt does not suggest that there were no reasonable steps that could have been taken to ensure compliance with the relevant provisions. The Court also noted that it is the responsibility of a new director at or prior to taking up appointment to make inquiries of the relevant officers of the company as to whether there are any moneys owing to the ATO.

There was a similar outcome in *FCT v Saunig* [2002] NSWCA 390 where it was held that what is 'reasonable' for a particular director should not be limited to the director's personal knowledge of the options available but, rather, the inquiry should extend to what a reasonable director in the director's position would have known **had proper inquiries been made**.

In this case, the director was unable to liquidate the company, despite attempts to do so, because he could not obtain the co-operation of his *"recalcitrant, non-cooperative or absent co-directors"*. The director was criticised for not obtaining appropriate accounting or legal advice sooner as, had he done so, he would have been provided with options that would have enabled him to comply with the law, even in the face of uncooperative co-directors.

The decision in *Canty v FCT* [2005] NSWCA 84 illustrates that a director is unlikely to be successful in arguing the 'took all reasonable steps' defence where they rely on a co-director to comply with the obligations of the DPR. In this case, the director delegated PAYGW responsibilities to a co-director and had been given (false) verbal assurances that tax liabilities were being paid on time.

TAX WARNING – The 'took all reasonable steps' defence

Consistent with the 'illness or some other good reason' defence (refer above), it seems it will be equally challenging for directors to avoid personal liability under the DPR by applying the 'took all reasonable steps' defence. In particular, in applying this defence, the Court is unlikely to look favourably on directors (including a **new director**) in these circumstances:

- A director who has delegated their responsibilities under the DPR to a co-director;
- A director who is ignorant of the law; and/or
- A director who is ignorant of the company's financial position.

Such an outcome reflects the serious nature of the obligations and responsibilities a director assumes by accepting the appointment to their role.

C. The 'reasonable care in relation to SGC' defence

On the basis that a company is more likely to be aware of its unremitted PAYGW obligations than its obligations under the SGAA, there is a specific defence available in relation to a director penalty that arises in relation to unpaid SGC (note that there is no corresponding defence in relation to unpaid PAYGW). This defence, contained in S.269-35(3A), is broadly available where the company incorrectly applied the SGAA (resulting in the SGC liability) but the position adopted was **'reasonably arguable'** and *reasonable care* was taken in applying the SGAA.

In this regard, S.284-15 provides that a matter is 'reasonably arguable' if (broadly) it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.

One of the most common errors made in applying the SGAA is incorrectly classifying an individual worker as an independent contractor rather than a common law employee, and not paying SG on the worker's behalf on that basis. Unfortunately, for the reasons set out below, it may be difficult to apply the 'reasonable care in relation to SGC' defence to such an error.

The first issue to note in this regard is that there has been a string of prominent decisions in which the Courts have found that purported individual contractors were in fact **common law employees** (i.e., for which the employer should have been paying SG). Refer to *Roy Morgan Research Pty Ltd v FCT [2010] FCAFC 52*, *Associated Translators & Linguists Pty Ltd v FCT [2010] AATA 260* and *Brilliant v FCT [2010] AATA 267*.

The volume of case law has provided well-established and tested principles that must be applied in distinguishing between a common law employee and a contractor (e.g., control, ability to delegate, achieving a result, integration of worker's activities in payer's business).

It is therefore important that payers be mindful of relevant case law when classifying workers. As a general rule of thumb, based on leading cases in this area, if an individual is **not** carrying on a business in their own right, there is a strong likelihood that a Court will determine they should properly be classified as an **employee**, rather than a **contractor**.

The second issue to be aware of in relation to this issue is that, even if a purported independent contractor is *not* an employee at common law, they may be **deemed** to be an employee for the purposes of the SGAA under the expanded definition of the term (in which case the payer is liable to pay SG on their behalf in any case). For example, for SGAA purposes, a worker providing services under a contract that is **wholly or principally for their labour** is **deemed** to be an employee. Refer to S.12(1) and S.12(3) of the SGAA).

As a result of these issues, there are concerns as to whether the 'reasonable care in relation to SGC' defence can apply, such that a director can avoid personal liability under the DPR, on the basis that the *incorrect classification* of a worker was 'reasonably arguable'. This is particularly so given the case law in this area, and the relevant statutory provisions, are all reflected in the ATO's own rulings on the subject. Refer to SGR 2005/1 and SGR 2005/2.

1.3 An NTAA checklist: Minimising the risk of personal liability under the DPR

It is evident from the above that company directors (past, present and future) face **significant exposure** where a company of which they are a director has unpaid SGC obligations. Fortunately, provided directors and advisors understand the regime, there are some simple strategies that can be implemented to assist in minimising that exposure, including the following:

Strategies to minimise exposure under the DPR	Considered?
1. Become familiar with the DPR (and the recent amendments) First and foremost, become familiar with the DPR, including the recent changes, which (among other things) have extended the scope of the DPR to **SG** obligations and introduced strict **'lockdown director penalties'**.	Yes / No
2. Correctly calculate and pay SG and/or SGC by the due date Ensure that the company **correctly calculates** SG (or SGC as applicable) and that the amounts are **remitted / paid** by the due date. If this is done, no director will have exposure under the DPR.	Yes / No
3. Ensure 'new' directors make use of their 30-day 'grace period' **'New directors'** can be personally liable for unpaid SGC, even if they were not appointed until *after* the 'due day' for these obligations. As such, new directors should carefully consider whether they should accept the appointment of director in the first place and, if so, conduct a robust **due diligence** to determine the SGC 'status' (at least) of the company within **30 days** of being appointed as a director.	Yes / No

Strategies to minimise exposure under the DPR	Considered?
4. Directors cannot simply retire to avoid personal liability Be mindful that it is **not** possible to simply **retire** as a director to avoid a director penalty in respect of an obligation(s) under the DPR, because there are circumstances in which a director continues to be exposed under the DPR even if they retire prior to the relevant 'due day'.	Yes / No
5. Report, report, report! In order to avoid the **'lockdown director penalties'**, directors should ensure amounts owing in respect of PAYGW and SG are **reported** to the ATO within the relevant 3-month period (even if a company is not in a position to pay these obligations), as follows: • **Existing** directors – report within 3 months of the 'due day'; and • **'New'** directors – report within 3 months of being appointed as director. Reporting ensures the option to have a penalty remitted, by winding up the company or appointing an administrator, remains available. To this end, it may be prudent for directors to review systems and processes to ensure they adequately support reporting and payment of SGC.	Yes / No
6. Liquidator or administrator must be appointed within 21 days Assuming the **'lockdown director penalties'** have *not* been triggered, the director is able to have a director penalty remitted where the company is placed into administration or liquidation, provided this is done within **21 days** of the ATO giving the DPN. To this end, ensure director contact details are up-to-date with ASIC so there is no delay in the director receiving a DPN.	Yes / No
7. Statutory defences are limited and may be subject to a time limit Whilst there are a number of **defences** that a director can potentially rely on to avoid personal liability under the DPR (e.g., the 'took all reasonable steps' defence), it is important to be aware that these defence only apply in *limited circumstances* and are also generally subject to a time limit.	Yes / No
8. Consider the DPR when devising an asset protection strategy Directors should keep potential exposure under the DPR in mind when devising an **asset protection strategy**. For example, a director (or potential shadow director) of a company should avoid accumulating private assets in their individual name and avoid 'controlling' other private investment entities.	Yes / No
9. Check exclusions if director insurance obtained Although a director may be able to take out **'director's insurance'**, most policies have an exclusion where personal liability arises under the DPR.	Yes / No
10. Seek expert advice It is vital that directors **seek expert advice** immediately when the company begins to experience financial difficulty. Avoiding the problem can be catastrophic for directors, as it can leave directors with no avenue to avoid personal liability under the DPR (and the introduction of the **'lockdown director penalties'** means exposure can arise in a very short space of time).	Yes / No