

Part B The Collection of Taxation Debts**18 BANKRUPTCY ACTION – CONDITIONS AND FACTORS TO CONSIDER**

The policy in this chapter is to be followed by Tax Office staff. We have made every effort to ensure it is technically accurate, but in the interests of clarity it has been written in 'plain English' and should not be read or interpreted like legislation. If you feel that something in the chapter is wrong or misleading, please advise the Tax Office.

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18.1 PURPOSE

18.1.1 This chapter will examine:

- some factors that should be considered before making the decision to bankrupt an individual debtor; and
- situations where bankruptcy action may be inappropriate.

The chapter discusses transactions which may be void against the trustee in bankruptcy. It also sets out the Commissioner's policy in regard to refunding amounts when a trustee in bankruptcy claims that a payment of tax is void.

18.2 LEGISLATION

18.2.1 The authority to commence action through the courts in order to recover outstanding taxation debts is provided by:

prior to 1 July 2000

- sections 209 (income tax), 220AAZA (reportable payments, tax instalment deductions and prescribed payment amounts), 221YR(1) (interest & royalties withholding taxes) *Income Tax Assessment Act 1936* (ITAA 1936);
- section 69 *Sales Tax Assessment Act 1992*;
- section 94 *Fringe Benefits Tax Assessment Act 1986*;
- section 50 *Superannuation Guarantee (Administration) Act 1992*;
- section 26 *Superannuation Contributions Tax (Assessment & Collection) Act 1997*;
- section 22 *Superannuation Contributions Tax (Members of Constitutionally Protected Superannuation Funds) Assessment and Collection Act 1997*; and
- section 17 *Termination Payments Tax (Assessment & Collection) Act 1997*.

on or after 1 July 2000

- section 255-5 of Schedule 1 to the Taxation Administration Act 1953 (TAA).

- 18.2.2 These statutes usually provide for the authority to be delegated to an officer who will be the Commissioner's duly authorised agent.

18.3 INTRODUCTION

- 18.3.1 The decision as to the most appropriate form of recovery action will depend on a number of factors and considerations. Legal recovery proceedings will usually be initiated if the debtor does not take steps to advise the Commissioner of an inability to pay and does not offer an acceptable proposal to pay the debt by instalments.
- 18.3.2 In some cases, the Commissioner or Deputy Commissioner may elect to cease further legal recovery proceedings because the debtor agrees to pay the debt and additional charges for late payment in full either by a specified date or by instalments over a period. However, in other instances, the Commissioner or Deputy Commissioner may consider it appropriate to continue with legal recovery proceedings, notwithstanding such an approach by the debtor. Some debtors only appreciate the consequences of bankruptcy at a late stage in proceedings and are then prompted to arrange their affairs to facilitate payment of their taxation debts.
- 18.3.3 Bankruptcy is the ultimate sanction for a debtor who does not pay or make acceptable arrangements to pay a debt. In bankruptcy, the debtor's property is vested in the trustee of the debtor's bankrupt estate for the benefit of creditors.
- 18.3.4 Individual debtors may voluntarily declare bankruptcy by filing their own petition (known as a *Debtor's Petition*) with the Official Receiver. Debtors may also become bankrupt as a result of a creditor presenting a creditor's petition in the Federal Court, but this may only occur if the debtor has committed an act of bankruptcy within the preceding six months.
- 18.3.5 Since its commencement on 5 May 2003, the *Bankruptcy Legislation Amendment Act 2002* has provided the Official Receiver with the discretion to reject a Debtor's Petition where it appears that the debtor could, within a reasonable time, pay all of the debts listed in the Statement of Affairs and that the Debtor's Petition represents an abuse of the bankruptcy system. Other amendments make it explicit that the Court can annul a bankruptcy regardless of whether or not the bankrupt was insolvent when the Debtor's Petition was accepted.
- 18.3.6 Upon entering bankruptcy, the property of the bankrupt estate is realised (that is, sold or otherwise disposed of) by the trustee in bankruptcy and, subject to certain priorities, distributed amongst the bankrupt's creditors. Subject to certain limitations (described at subsection 116(2) of the *Bankruptcy Act 1966* (Bankruptcy Act)), the property that is divisible among creditors includes all property that belonged to, or was vested in, a bankrupt at the commencement of the bankruptcy, or which was acquired by the bankrupt after the commencement of the bankruptcy and before his or her discharge. The effect of subsection 116(2) is to permit the bankrupt to retain certain items of property. For instance, the bankrupt is allowed to retain some items of personal property, such as clothing and ordinary household goods, as well as a motor vehicle whose aggregate value does not exceed the amount prescribed by the regulations (this value presently stands at \$5000). Since 5 May 2003, creditors have been able, by way of special resolution, to permit a

- bankrupt to retain sentimental property of a prescribed kind (such as sporting trophies and medals).
- 18.3.7 Bankruptcy does not exist solely as a remedy for creditors. It seeks to serve several purposes, including:
- (i) to protect both debtors and creditors;
 - (ii) to provide a process by which creditors receive a distribution from the bankrupt's estate. (The distribution is generally in proportion to the amount owed);
 - (iii) to relieve debtors of their debts so that they may start afresh; and
 - (iv) to permit an examination of the debtor's affairs.
- 18.3.8 A Creditor's Petition cannot be presented unless the debtor has committed an act of bankruptcy within the preceding six months and owes the creditor at least \$2000. In general terms, an act of bankruptcy is an action (or inaction) on the part of the debtor which indicates that the debtor is unable to pay a creditor's debt. Subsection 40 (1) of the Bankruptcy Act lists a large number of acts and omissions which constitute acts of bankruptcy for the purposes of filing a Creditor's Petition.
- 18.3.9 When the Tax Office files a Creditor's Petition as part of bankruptcy proceedings, it typically relies upon the act of bankruptcy defined at paragraph 40(1)(g) of the Bankruptcy Act. That paragraph states that a debtor's non-compliance with a bankruptcy notice within the requisite time constitutes a commission of an act of bankruptcy. If the Court grants a sequestration order, the debtor becomes bankrupt and a registered Trustee in Bankruptcy or the Official Trustee is appointed to deal with creditors' claims against the estate.
- 18.3.10 The Bankruptcy Act describes the role and responsibilities of a trustee in bankruptcy and details what assets of the bankrupt estate are available for distribution. Bankruptcy usually continues for a period of three years and, during that period, the bankrupt is subject to certain restrictions. As a result of changes introduced by the *Bankruptcy Legislation Amendment Act 2002*, bankrupts are no longer able to apply for early discharge from bankruptcy (where the date of the bankruptcy is after 5 May 2003).
- 18.3.11 In addition to realising available assets, the trustee may also collect a portion of the income the bankrupt earns during the bankruptcy. These income contributions represent 50 cents from every dollar that the bankrupt earns above a certain threshold, calculated by the Trustee according to the bankrupt's individual circumstances (eg number of dependants). The funds arising from these sources are available for distribution among creditors.
- 18.3.12 A trustee is required to notify all known creditors of the trustee's appointment and to provide relevant details of the bankruptcy order. The Tax Office will lodge a proof of debt with the trustee for any outstanding tax debt. Where outstanding debts retain a statutory priority (such as amounts due as superannuation guarantee charge (SGC) within the meaning of the *Superannuation Guarantee (Administration) Act 1992*, or general interest charge in respect of non-payment of the superannuation guarantee charge, and tax instalment deductions and certain other source deduction liabilities which fell due before 1 July 1993), the Commissioner retains preferential status over other creditors in respect of

- those liabilities. The trustee is also required to notify all creditors of any proposed distribution of a dividend.
- 18.3.13 Under the Superannuation Guarantee provisions, an employer needs to provide a minimum level of superannuation for their employees to a Fund by the due date, or, if they fail to do so, pay the SGC. In order to avoid the need for multiple proofs of debt, where there is no SGC debt on the SGC system, tax officers should contact the trustee to ascertain if the employer has complied with their obligations for all relevant years under the Superannuation Guarantee provisions and to also establish whether a dividend is likely. Where the employer has failed to comply with their obligations and a dividend is likely, the trustee should be requested to provide the relevant details to enable the Tax Office to raise an assessment. Where no dividend is likely, no further action need be taken.
- 18.3.14 Where the bankruptcy occurred prior to 5 May 2003, a bankrupt has a right to apply for an early discharge from bankruptcy. The trustee or Official Trustee may object to a bankrupt's discharge. This usually occurs where there is good reason to believe that the bankrupt has not brought all assets to account or that the bankrupt could have made (or could yet make) more meaningful contributions to the estate. See paragraphs 149D(a) to (e) of the Bankruptcy Act for grounds for objecting to discharge.
- 18.3.15 When debtors are discharged from bankruptcy, they are released from the debts that were provable in the bankruptcy. This has an important effect on the application of credits arising from assessments relating to income years after the date of the sequestration order.
- 18.3.16 Until a bankrupt is discharged, any excess credits, such as credits for tax instalments deductions, should be applied in reduction of any liability (both post and pre sequestration) before any remaining balance is refunded to the debtor (*Taylor v. DFC of T 87 ATC 4441*). However, once a bankrupt has been discharged, the pre-sequestration debt is considered to be irrecoverable at law. Any excess credits arising after the bankrupt's discharge will be refunded, assuming no other debts have arisen.
- 18.3.17 The only exception to this is when an assessment relating to a pre-sequestration year results in a credit. This should be offset against the bankrupt's debt regardless of whether they have been discharged or not.
- 18.3.18 Tax losses incurred prior to the date of bankruptcy are not allowable deductions in future tax years.
- 18.3.19 Even if the bankruptcy is later annulled under section 74 of the Bankruptcy Act because the creditors have accepted a proposal for a composition or scheme of arrangement, and the bankrupt is released from some or all of the provable debts, the tax losses incurred before the date of bankruptcy are not allowable deductions in future tax years.
- 18.3.20 With the introduction of the *Higher Education Funding Amendment Act 2001* (HEFAA 2001), and effective from 7 June 2001, Higher Education Contribution (HEC) debts related to the pre-bankruptcy period which comprise the bankrupt's accumulated HEC debt and the unpaid part of the semester debts incurred before bankruptcy are provable by the Commissioner, but will not be extinguished on discharge from bankruptcy, if not fully recovered. The assessment debt, which is raised as part of the income tax assessment, is provable and is extinguished on

discharge. It should be noted that, as per the *Student Assistance Act 1973*, accumulated Student Financial Supplement (SFSS) debts are not provable in bankruptcy, and nor are they extinguished upon discharge from bankruptcy.

- 18.3.21 HEC assessment debts assessed to the post-bankruptcy periods (ie after the date of bankruptcy) are not provable.

A Bankruptcy part way through a financial year

- 18.3.22 Previously, a debtor who was made bankrupt part way through a financial year was still personally liable for a debit assessment that issued for that financial year. (That is, the debt arising was not apportioned between pre- and post-sequestration periods, and nor did it form part of the Commissioner's claim against the bankrupt estate of the debtor).
- 18.3.23 The decision of the Full Federal Court in *DC of T v. Jones* (1999) FCA 308 confirmed that a part-year tax liability which accrues up to the date of bankruptcy is a provable debt for bankruptcy purposes.
- 18.3.24 It is therefore necessary for the bankrupt taxpayer to lodge two income tax returns for the financial year in which they become bankrupt. The first assessment, from the commencement of the year of income to the date of bankruptcy is a provable debt in the bankruptcy. The second assessment, for the balance of the financial year, is a debt for which the taxpayer is personally liable.

B Bankruptcy and prior years assessments.

- 18.3.25 The taxation affairs of debtors at the date of bankruptcy are frequently in an unsatisfactory state. Taxation debts for completed years of income are provable under section 82 of the Bankruptcy Act even where the assessment issues after the date of bankruptcy. If a debt is provable, the debtor is released from the debt on discharge from bankruptcy (as per section 153 of the Act). It is therefore important that the debtor's taxation affairs be brought up to date for completed years of income prior to the date of bankruptcy before lodging a proof of debt.
- 18.3.26 The debtor should be asked to lodge outstanding returns and/or other documents to enable their taxation liability to be determined. If the debtor is uncooperative, or if the lodging of the proof of debt will be unreasonably delayed, arrangements should be made:
- (i) for default assessments to issue under section 167 *Income Tax Assessment Act 1936*, section 73 *Fringe Benefits Tax Assessment Act 1986* and/or section 101 *Sales Tax Assessment Act 1982*, section 36 *Superannuation Guarantee Administration Act 1992* and section 22 of Part VI of the TAA (for indirect taxes). These provisions enable original or amended assessments to be raised; and/or
 - (ii) for estimates to be raised for debts due under the remittance provisions (see the chapter entitled 'Estimating a Liability').

C The implications of bankruptcy

- 18.3.27 There are a number of restrictions on a debtor who becomes bankrupt. These can be summarised as follows:

- (i) A bankrupt is unable to enjoy the legal or beneficial ownership of any assets until discharged from bankruptcy (although the trustee will not realise personal property such as clothing and ordinary household items or a motor vehicle in which the bankrupt has no more than \$5000 equity).
- (ii) A bankrupt must not obtain credit exceeding a specific amount without advising the credit provider of the occurrence of the bankruptcy.
- (iii) The bankrupt is subject to a compulsory income contribution scheme whereby 50 cents in the dollar of net income above a certain indexed threshold is contributed to the bankrupt estate.
- (iv) The bankrupt must surrender his or her passport and is unable to travel overseas without the permission of the trustee or, in some cases, the Court.
- (v) There is a prohibition on acting as a director, or managing a corporation.
- (vi) Details of the debtor's bankruptcy are permanently recorded on the National Personal Insolvency Index (NPII).
- (vii) The various laws and rules of some professional bodies may preclude bankrupts from practising or may restrict their activities within a profession. Basically, these laws and rules are designed to protect the community and go somewhat further than the provisions of the Bankruptcy Act, itself. They generally work on the premise that bankrupts have demonstrated that they are not capable of managing their own affairs and, therefore, should not be in a position to advise others or manage the financial affairs of others.

18.4 POLICY

- 18.4.1 Bankruptcy is a valid option for dealing with debtors, and the Commissioner, as a creditor, will not hesitate to use this process in appropriate circumstances. However, the decision to institute bankruptcy proceedings against a debtor will not be taken lightly, nor will it be taken to 'punish' a debtor. The Commissioner determines whether subsection 52(2) of the Bankruptcy Act might apply.
- 18.4.2 Subsection 52(2) of the Bankruptcy Act provides that the Court may dismiss a Creditor's Petition if it is not satisfied as to the accuracy of the petition or if the debtor is able to persuade the Court that the debts can be paid. This section of the Act was examined in *Keenan v. DCT* (1999) 99 ATC 4465 at 4466, where the Creditor's Petition was dismissed on the basis that the taxpayer was solvent and that the taxpayer was identified as one who did not want to pay, as opposed to a taxpayer who could not pay. Accordingly, the Commissioner should be satisfied that the debtor is, in fact, insolvent.
- 18.4.3 However, the mere fact of a taxpayer being able to show that their assets exceed their liabilities is not proof of solvency. This was examined in the judgment of *Lakatos v. DCT* (1996) 33 ATR 145 at 148; where even though the taxpayer had assets whose value substantially exceeded their liabilities, it could not be shown to the satisfaction of the court that the debts could be paid when they fell due.

18.4.4 While each case must be considered on its merits, the following are some factors that should be taken into consideration, in deference to subsection 52(2) of the Bankruptcy Act and the judgments in *Keenan* and *Lakatos*:

- (i) The financial position of the debtor.
 - If there are no available assets which can be realised to satisfy the debt, bankruptcy action may not be worthwhile. Accepting payment of the debt and additional charges for late payment over a period of time may be a cheaper and more viable alternative in these cases (although it would be difficult for debtors with a history of broken promises to satisfy the Commissioner that they could/would pay over time).
 - It may be unwise to agree to accept payment over time if it is likely another creditor might initiate bankruptcy action. In these cases, any payments made during the relation back period (ie the period starting from the earliest act of bankruptcy and ending on the date the person is made bankrupt, where that act of bankruptcy occurs within six months immediately before the person is made bankrupt) may have to be repaid to the trustee.
 - Officers should also recognise that circumstances often arise wherein bankruptcy is more suitable than other forms of recovery - even though the debtor may appear to have no tangible assets. It is not unusual for debtors to structure their affairs in such a way as to ensure that they have no assets in their own name but, nevertheless, have access to, and the use of, assets in the name of an associated entity, such as a family trust or a company.
 - Bankruptcy will enable the trustee to examine the debtor and take steps to recover certain dispositions of assets. The Commissioner, through the trustee in bankruptcy, may request the Federal Court to summon the bankrupt or any other individuals whom he suspects may have knowledge of the bankrupt's financial affairs. A less costly administrative procedure is provided under section 77C of the Bankruptcy Act.
 - The bankrupt or the person summoned to appear will be examined before the court or registrar with a view towards discovering any undisclosed details of the bankrupt's property. The bankrupt or the person summoned may be ordered to produce any documents relating to the bankrupt's affairs. A similar but less costly administrative procedure is provided under section 77C of the Bankruptcy Act.
- (ii) The nature of the debt
 - It may be appropriate to take bankruptcy action to stop a debt from escalating rapidly. For example, pay as you go withholding amounts are required to be remitted (monthly, in many cases) and if those remittances are not paid, the debt will escalate. A debtor trying to avoid bankruptcy would need to demonstrate that steps have been taken to stop debts from escalating.

- Some debts are a combination of disputed and undisputed debts. Bankruptcy action may be taken where the debt includes a significant amount of undisputed debt. The chapter entitled 'Recovering disputed debts' discusses the Commissioner's approach to predominantly disputed debts. The fact that the debtor has a dispute is a relevant factor to be taken into account, but is not in itself sufficient to defer bankruptcy action. The trustee in bankruptcy can decide whether or not to proceed with any dispute, based on their own appreciation of the debtor's case. The Commissioner will not attempt to influence the trustee's decision.
- (iii) The future income of the debtor
- If it can be shown that the debtor's financial position will improve (evidenced by financial statements and any reports which may have been obtained from an insolvency practitioner) and the debt and the additional charges for late payment can be fully satisfied at some time in the future, it may be appropriate to consider accepting payment over a period of time. The onus would be on the debtor to demonstrate their ability to pay within that period. This option may not be appropriate for a debtor who has a history of failing to honour promises to pay.
- (iv) The risk to the revenue
- If it is evident or becomes apparent that the debtor is avoiding payment or taking steps to limit their ability to pay, it may be appropriate to take immediate bankruptcy action.
- (v) The cost of bankruptcy and the likely return
- Ideally, the cost of any bankruptcy action should be recouped from the amount recovered from the bankrupt estate. Where outstanding debts retain a statutory priority, the Commissioner retains preferential status over other creditors. This factor should be considered in assessing the likely return from a bankruptcy action. However, this is unlikely to be the case in the majority of bankruptcies, and many cases that get to this stage do not return any dividend to unsecured creditors.
 - The cost/benefit analysis of bankruptcy action is an appropriate test of effectiveness, but should not stand alone as a consideration. The return from bankruptcy is not restricted to any dividend from the bankruptcy. The debtor's bankruptcy may prevent the rapid escalation of debt, eg withholding liabilities.
 - In assessing whether to bankrupt a debtor, any last minute offers to make payments over time need to be assessed with reference to the debtor's payment history and their ability to comply with the proposed offer of payment.
- (vi) Whether special circumstances exist
- It may be inappropriate to take bankruptcy action in some cases (for example, against an elderly or handicapped debtor with limited or no assets).

- 18.4.5 In considering whether to bankrupt a debtor, the Commissioner needs to be alert for dispositions of property which indicate that the debtor is divesting himself or herself of assets. These dispositions would be void against the trustee in bankruptcy under the antecedent transaction provisions, if the debtor were to be declared bankrupt.
- 18.4.6 The relevant provisions of the Bankruptcy Act which deal with these transactions are sections 120 (undervalued transactions), 121 (transfers to defeat creditors) and 122 (preferences). Each section is outlined below. The onus is on the trustee in bankruptcy to establish that the pre-conditions of each section have been satisfied.
- 18.4.7 By the amended section 120, transactions are void against the trustee in bankruptcy if the transfer of property was for no consideration or for a consideration less than the market value of the property at the time of the transfer, and the transfer took place in a period beginning five years before the commencement of the bankruptcy. Certain transactions are exempted from section 120, including payments of tax under a law of the Commonwealth. Transfers are not void if the transfer took place more than two years before the commencement of the bankruptcy and the transferee (ie purchaser) can prove that at the time of the transfer the debtor was solvent. The term 'solvent' is defined in subsection 5(2) of the Bankruptcy Act to include a person who is able to pay all their debts as and when they become due and payable. Section 120 does not affect the rights of a person who acquired property in good faith, and paid market value for the property. Furthermore, certain transactions are deemed to have no value as consideration for the purposes of section 120.
- 18.4.8 The amended section 121 deals with transfers to defeat creditors. A transfer of property is void if:
- the property would probably have become part of the debtor's estate or would probably have been available to creditors if the property had not been transferred; and
 - the main purpose in making the transfer was to prevent the property from becoming divisible property among creditors or to hinder or delay the process of making property available to creditors.
- 18.4.9 The debtor will be taken to have the main purpose of putting an asset beyond the reach of creditors if it can reasonably be inferred from all the circumstances that at the time of the transfer, the debtor was (or was about to become) insolvent. The Act provides for certain defences that prevent the transfer being declared void (eg the consideration given was at least the market value of the property). Certain transactions are deemed to have no value as consideration for the purposes of section 121.
- 18.4.10 Section 122 makes transactions by an insolvent debtor which give a creditor a preference, priority or advantage over other creditors void against the trustee. Transfers are not void if the transfer was made in the ordinary course of business, in good faith and for market value.
- 18.4.11 The Commissioner may choose to provide information about the debtor to the trustee in bankruptcy where the Commissioner believes that it is reasonably likely that the provision of such information will lead to the Commissioner receiving a greater dividend or distribution from the bankrupt's estate. Before disclosing any information, the Tax Office decision-maker must consider two separate pieces of legislation. The first

is the relevant secrecy provision of the TAA and similar provisions in other acts (eg section 16 of the *Income Tax Assessment Act 1936*). The decision should be guided by Chapter 2 of the *ATO Receivables Policy* and, if disclosure is permissible under the relevant section, the Tax Office decision-maker may have a discretion to disclose information to the trustee. It is important to note that the relevant secrecy provision is the one under which the information was obtained. Where it is not clear that the information can be given without breaching secrecy provisions, advice should be sought from the Legal Services Branch of the Tax Office.

18.5 CLAIMS AGAINST THE COMMISSIONER IN REGARD TO A PAYMENT OF TAX

- 18.5.1 It is possible that claims will be made against the Commissioner by a trustee in bankruptcy, on the basis that a payment of tax is void because it gave the Commissioner a preference, priority or advantage over other creditors. The Commissioner is not immune from such claims, and these may extend to all tax types.
- 18.5.2 Unlike preference claims brought by liquidators pursuant to the provisions of the *Corporations Act 2001*, a transaction may be void under Section 122 and recovered at the election of the trustee in bankruptcy. The Commissioner will consider any such claims and, if satisfied that the transaction is void, and that no valid defence exists, will consent to refunding the amount to the trustee. If he is not satisfied, or if he feels that a valid defence exists, then the Commissioner may refuse to refund the amount claimed, and may defend any action for recovery brought by the trustee.
- 18.5.3 Any claims by trustees for repayment of an alleged preference should be discussed with the case officer's team leader. All claims are to be brought to the attention of your relevant regional technical area as soon as the claim is received. Generally, the relevant technical area will provide advice for cases involving a claim for refund of a purported void preference. No response is to be given to the trustee until the advice of the relevant technical area has been received.