TR 98/18 - Income tax: section 218 notices and sales of secured property

Australian Taxation Office

Taxation Ruling
Income tax: section 218 notices and sales of secured property

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Preamble

*The number, subject heading, and the **Class of person/arrangement**, **Ruling** and **Date of effect** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling clarifies the circumstances in which the Commissioner relies upon the statutory power under section 218 of the *Income Tax Assessment Act 1936* ('the Act') and similar provisions in other Acts to require, by notice, the payment of part or all of the purchase price of mortgaged property to the Commissioner, rather than to the holder of the security over the property.

Class of person/arrangement

2. This Ruling applies to any purchaser of, or holder of security over, property being sold where a notice under section 218 ('a section 218 notice') requiring the payment of the whole, or part, of the purchase price to the Commissioner is served upon the purchaser, or the purchaser's agent or solicitor.

3. This Ruling does not apply to:

(a) sales of property subject to retention of title clauses, such as in *Aluminium Industrie Vaassen BV v. Romalpa Aluminium Ltd* [1976] 2 All ER 552; [1976] 1 WLR 676;

(b) funds affected by a solicitor's lien for costs, where such costs are already due: see *Heath & Anor v. DFC of T* 95 ATC 4430; (1995) 30 ATR 536; or

(c) mortgages of land under old system title.

Definitions

4. In this Ruling:

'mortgage' includes any instrument purporting to create a secured interest in specific property, such as a bill of sale or a fixed or floating charge;

'mortgagor' and **'mortgagee'** have a corresponding meaning;

'registered mortgage' means a mortgage recorded in a statutory register maintained by a State or Territory (recording of an interest normally provides some protection or priority to the interest against later claimants);

'unregistered mortgage' means a mortgage that is not a 'registered mortgage' (an unrecorded interest is normally unprotected against later claimants who have no notice of the unrecorded interest);

'purchaser' refers to a person seeking legal title, usually under a written contract of sale, to property in which a mortgagee holds, or purports to hold, a secured interest; and

'vendor' refers to a person who currently holds legal title to property in which a mortgagee holds, or purports to hold, a secured interest, i.e., the taxpayer.

Ruling

5. Subject to paragraph 6, when exercising the discretionary powers under section 218, the Commissioner does not require a purchaser to pay the whole, or part, of the purchase price of mortgaged property to the Commissioner to the detriment of the mortgagee's secured interest.

6. Where there is evidence that the purpose of a mortgage (whether registered or unregistered) was to defeat the Commissioner's recovery powers, the Commissioner requires payment of all or part of the purchase price by the purchaser.

Date of effect

7. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Previous Rulings

8. This Ruling replaces Taxation Rulings IT 2042, IT 2079 and IT 2313, which are now withdrawn.

Explanations

9. Subsection 218(1) of the Act allows the Commissioner, by notice in writing, to require persons who owe or may subsequently owe money payable to a taxpayer, to pay the money to the Commissioner to the extent of meeting the taxpayer's tax liability. Service of a notice creates a section 218 statutory charge in favour of the Commissioner: *DFC of T v. Donnelly & Ors* (1989) 89 ALR 232; 89 ATC 5071; (1989) 20 ATR 1331 (*Donnelly*); *Clyne & Anor v. DFC of T & Anor* (1981) 150 CLR 1; 81 ATC 4429; (1981) 12 ATR 173 per Brennan J (at CLR 26; ATC 4442; ATR 189).

10. The wide terms of section 218 are not subject to the merely potential interests of persons other than the taxpayer: 'Section 218 is expressed in wide terms and is intended to have a wide application': per Hill J in *Donnelly* at ALR xxx; ATC 5087; ATR 1347.

11. On registration, a mortgage gives to the mortgagee a charge over the mortgaged property and a right to exercise various powers. The mortgagor has the right to the sale proceeds but can only effectively exercise the right if able to give clear title to the prospective purchaser by repaying the mortgagee. The mortgagee is only entitled to receive the proceeds of sale when exercising the power of sale after default by the mortgagor. Except for a floating charge, the mortgagee has no direct right to the proceeds of sale of the mortgaged property until the power of sale in the mortgage is exercised (the right is subject to a trust in favour of the mortgagor over any surplus: *Bank of New South Wales v. Adams* [1982] 2 NSWLR 659).

12. For some floating charges, default by a mortgagor causes the charge to crystallise either automatically or at the option of the mortgagee, giving the mortgagee an actual, rather than potential, interest in the proceeds of the sale of the secured property. After such default and crystallisation, the mortgagee's entitlement to the proceeds of sale has priority over a subsequent charge created by service of a section 218 notice on the purchaser: *DFC of T v. Lai Corporation Pty Ltd and Ors* (1986) 83 FLR 63; (1986) 4 ACLC 96; 86 ATC 4085; (1986) 17 ATR 256; *Tricontinental Corporation Ltd & Anor v. FC of T & Ors* (1986) 85 FLR 273; 86 ATC 4453; (1986) 17 ATR 803.

13. Where a mortgagor has not defaulted before settlement, the mortgage gives the mortgagee no interest in the sale proceeds. At settlement, the sale proceeds belong to the vendor and the mortgagee has no protection against the operation of a section 218 notice: *DFC of T v. Lai Corporation Pty Ltd and Ors*. When the proceeds are payable by the purchaser to the vendor under the contract of sale, the Commissioner's rights under section 218 become a right to require immediate payment from the recipient of the notice, that is, the purchaser: see *Donnelly*.

Effect of conveyancing practices

14. Standard conveyancing practice is for the purchaser to obtain clear title to the property. This necessarily involves repaying any mortgage. At settlement, in a simple situation, the vendor directs the purchaser to draw a cheque in favour of the mortgagee for the amount of the mortgage and another to the vendor for the balance of the purchase price.

15. The Commissioner normally requires the purchaser to pay the amount of the vendor's tax debt, identified in a section 218 notice, from the balance of the purchase price. This allows a bona fide mortgagee, such as an independent financial institution, to collect their secured debt on settlement.

16. A section 218 notice served on the purchaser applies to the proceeds of sale, while the mortgagee's security is over the property being sold. A decision not to enforce this notice is at the Commissioner's discretion. This discretion is exercised to increase administrative efficiency in collecting tax debts and minimise adverse impacts on the community.

Purported or contrived mortgages

17. There have been recent cases where a vendor has entered into a bogus or specious mortgage in an attempt to defeat the Commissioner's recovery of tax debts and the claims of other creditors. These transactions usually involve family members or business associates making alleged loans of unsubstantiated, but significant, sums of money in return for a mortgage over real property or other assets after the Australian Taxation Office ('the ATO') has commenced action.

18. Where ATO investigations indicate that the purpose of the transactions was to defeat the Commissioner's recovery powers, the Commissioner relies on the power in subsection 218(1) requiring the

payment to him of so much of the purchase price as is necessary to recover the vendor's tax debt.

19. This power is relied on where the Commissioner has reasonable grounds for questioning the authenticity of an alleged mortgage.

20. The taxpayer and the purported mortgagee may have committed a criminal offence where an arrangement was intended to defeat the Commissioner's recovery powers. The Commissioner will generally refer these cases to the Commonwealth Director of Public Prosecutions.

21. After a section 218 notice is served on a purchaser, the purchaser may decide not to proceed with the sale because the vendor is unable to provide clear title without the consent of the mortgagee. This is substantially similar to other events likely to frustrate the contract of sale, such as the death, insanity or insolvency of the vendor, or the detection of a defect in title.

Features of contrived arrangements

22. Purported mortgages may involve some or all of the following common factors, although many of these may also be present in legitimate transactions:

(a) there is no independently verifiable evidence of the mortgage transactions, especially the creation of the mortgage and the movement of any funds under it, such as the original transfer of the principal to the mortgagor and any repayments made on the principal or interest;

(b) funds actually move between the parties but they do not correspond, even approximately, to the amount of the mortgage or the time of creation of the alleged mortgage;

(c) the first indication of the existence of the mortgage is after the commencement of ATO audit action on the taxpayer's financial affairs or on those of entities related to the taxpayer; the purchaser may even be unaware of the existence of any such mortgage until after the service of the section 218 notice;

(d) the purported mortgagee is not an independent financial institution;

(e) the purported mortgagee has close personal or business ties to the taxpayer;

(f) the purported mortgage is unregistered;

(g) stamp duty is not paid on the purported mortgage; or

(h) the purported mortgagee did not possess sufficient means to have raised the funds necessary for the alleged mortgage.

Although these factors are viewed as constituting indicators of risk, none of them is conclusive and there may be other factors that are relevant in specific cases.

Examples

Example 1

23. Brian and Barbara Baker operate a small pastry business. The ATO commences an audit of their financial affairs. Brian and Barbara appear to own their home and the delivery van they use in the business as tenants in common in equal shares. At the end of the audit, they each receive large debit assessments. Their home is put up for sale and quickly sold and the auditor learns of this before settlement.

24. A section 218 notice is served upon the purchaser requiring payment of the tax liability for Brian and another is served for Barbara's liability. Brian and Barbara then notify the purchaser that there is an unregistered mortgage over the property in favour of their 21 year-old daughter, Belinda, who is a University student relying on AUSTUDY to support her. The purchaser advises the ATO of the details of this unregistered mortgage and seeks guidance. As the alleged mortgage has the hallmarks of a contrived arrangement and the Bakers are unable to provide any convincing evidence of it being *bona fide*, the Commissioner relies upon the power granted under section 218 and enforces the notices.

Example 2

25. In addition to the facts in **Example 1**, soon after this, the Bakers decide to sell their delivery van. A buyer is found who is prepared to pay $21,000 and a written agreement is signed for the van's transfer after certain repairs are carried out by the Bakers. The auditor discovers this and serves a section 218 notice on the purchaser. The Bakers then claim there is an unregistered bill of sale over the van in favour of their son, Barry. The purchaser advises the ATO of the details of this unregistered bill of sale.

26. Barry is 32 years old and is a successful car dealer. From available financial records, the auditor determines that the Bakers did receive a large sum of money from Barry just before they purchased the van three years ago. There have also been several payments by the Bakers to Barry, approximately every three months, which they say

were repayments of the loan. As a result, although the bill of sale is unregistered and the insurance company has not been advised of Barry's interest in the vehicle, the Commissioner does not rely upon his power under section 218 to recover the full amount. An amended section 218 notice is issued to exclude the amount of Barry's interest.

Example 3

27. Frederica Fisher operates a seafood distribution network covering 25 dealerships. Her operation is subjected to an audit, which results in a substantial increase in her tax liability for several years. She is listed as the registered proprietor of the business. Soon after the assessments are issued, the business is sold. The auditor arranges the service of a section 218 notice upon the purchaser to secure payment of Frederica's debt.

28. However, after service, the purchaser advises the ATO that there is a floating charge over the trading stock of the business in favour of Frederica's former business partner, Felix Filet. This liability has to be met under the terms of the contract. The auditor investigates and determines that the charge was a term of the agreement to dissolve the partnership that originally started the business, with regular payments being made to Felix at the end of each of the intervening financial years. Accordingly, the auditor arranges the issue of a replacement notice to exclude the amount of the (now) crystallised charge.

Example 4

29. Steven Soap runs the Pacific Bubble Company Pty Ltd, which is subject to an ATO audit. Steven owns the company's factory, subject to a registered mortgage in favour of Credit Guarantee Australia (CGA). During the audit, Steven explains that there is also an unregistered second mortgage over the land in favour of his wife, Sally. Sally has no income other than a small dividend as a shareholder/director of the company and had no significant assets or funds from which she could have drawn the mortgage advance when it was alleged to have been made. There is no evidence of the transfer of funds from Sally to Steven or to any person at Steven's direction.

30. Just before completion of the audit, the auditor notices that the factory is 'For Sale' and it is sold within a few days. The auditor completes the audit, the notice of assessment is issued and is payable twenty days before settlement is due to take place. A section 218 notice is then served upon the purchaser, requiring the payment to the Commissioner of the balance of the purchase price after the discharge of the mortgage to CGA. However, the notice includes that part of the purchase price to which the alleged second mortgage relates.

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- garnishees
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legislative references
- ITAA 218
- ITAA 218(1)

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