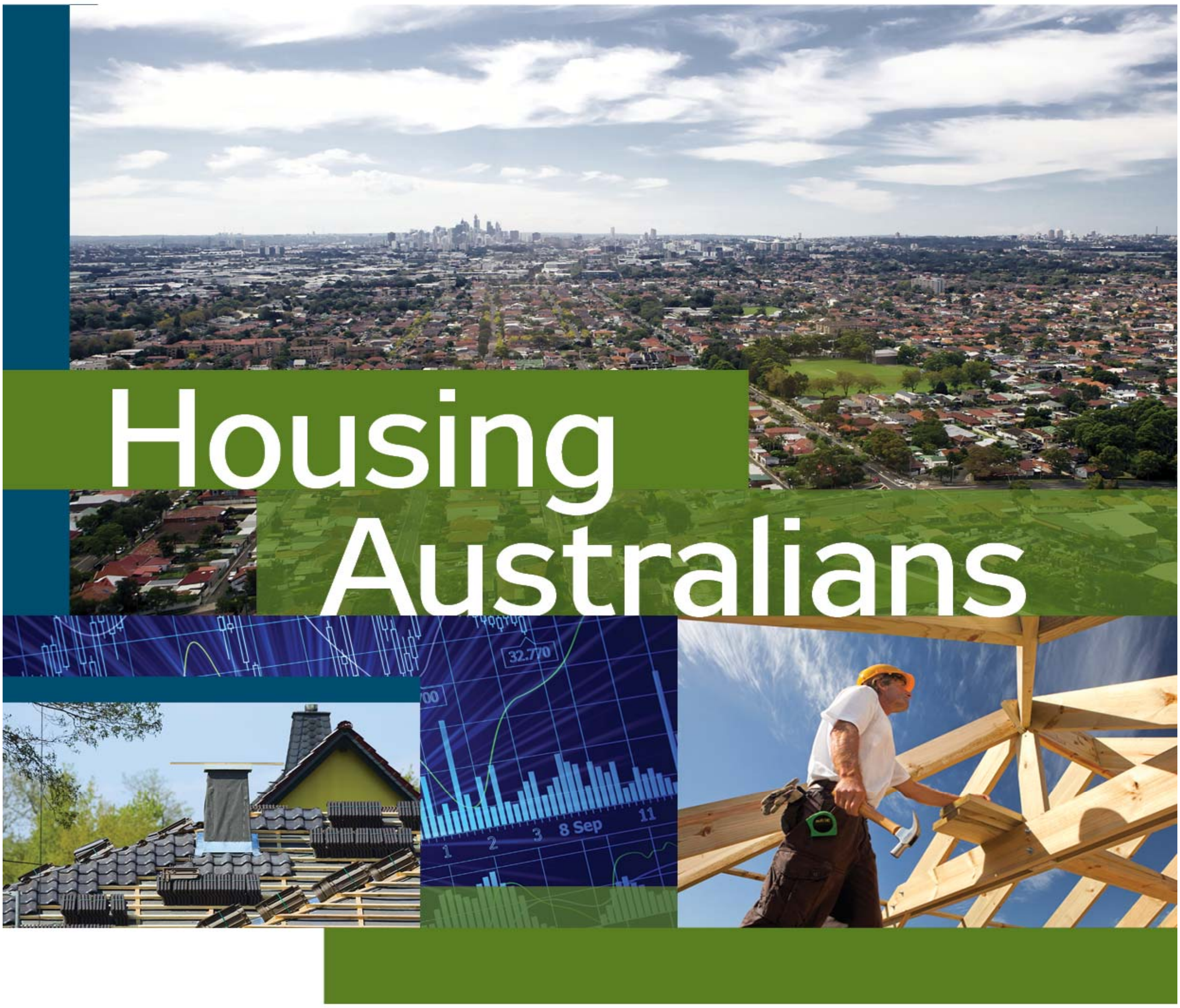
HOUSING INDUSTRY ASSOCIATION



Submission to Treasury
in response to the

Combatting Illegal Phoenixing consultation paper

31 October 2017

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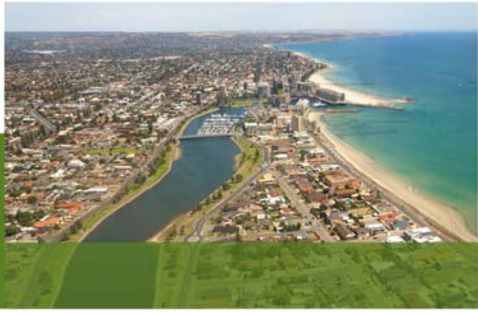

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ABOUT THE HOUSING INDUSTRY ASSOCIATION

The Housing Industry Association (HIA) is Australia's only national industry association representing the interests of the residential building industry, including new home builders, renovators, trade contractors, land developers, related building professionals, and suppliers and manufacturers of building products.

As the voice of the industry, HIA represents some 40,000 member businesses throughout Australia. The residential building industry includes land development, detached home construction, home renovations, low/medium-density housing, high-rise apartment buildings and building product manufacturing.

HIA members comprise a diversity of residential builders, including the Housing 100 volume builders, small to medium builders and renovators, residential developers, trade contractors, major building product manufacturers and suppliers and consultants to the industry. HIA members construct over 85 per cent of the nation's new housing stock.

HIA exists to service the businesses it represents, lobby for the best possible business environment for the building industry and to encourage a responsible and quality driven, affordable residential building development industry. HIA's mission is to:

> *"promote policies and provide services which enhance our members' business practices, products and profitability, consistent with the highest standards of professional and commercial conduct."*

The residential building industry is one of Australia's most dynamic, innovative and efficient service industries and is a key driver of the Australian economy. The residential building industry has a wide reach into manufacturing, supply, and retail sectors.

The aggregate residential industry contribution to the Australian economy is over $150 billion per annum, with over one million employees in building and construction, tens of thousands of small businesses, and over 200,000 sub-contractors reliant on the industry for their livelihood.

HIA develops and advocates policy on behalf of members to further advance new home building and renovating, enabling members to provide affordable and appropriate housing to the growing Australian population. New policy is generated through a grassroots process that starts with local and regional member committees before progressing to the Association's National Policy Congress by which time it has passed through almost 1,000 sets of hands.

Policy development is supported by an ongoing process of collecting and analysing data, forecasting, and providing industry data and insights for members, the general public and on a contract basis.

The Association operates offices in 23 centres around the nation providing a wide range of advocacy and business support services and products.

1. INTRODUCTION

HIA welcomes the opportunity to make a submission in response to the Government's *Combatting Illegal Phoenixing* consultation paper.

In the first instance, it is important to note that HIA does not support individuals who engage in illegal phoenixing. Individuals who hide behind the shield of a company to incur debts such as payments due to employees and subcontractors without any intention of paying those debts, abuse the corporate form and obtain an unfair competitive advantage over the majority of businesses that comply with their obligations, are acting outside the legal obligations and community expectations. Strong punishment and sanctions should apply to such individuals.

Despite the number of reviews undertaken, and reforms introduced over the last decade, including the recent changes to the Fair Entitlements Guarantee (FEG) scheme, gaps remain in the current laws to address phoenixing and their enforcement by the relevant regulatory agencies.

In principle, HIA supports many of the measures proposed in the consultation paper to address these gaps. However some options may amount to "overcapture" and warrant further consideration before being finalised.

The incorporated entity remains the chosen (and best) legal structure for hundreds of thousands of businesses. Any additional laws should not dilute the economy-wide benefits of incorporation nor simply be another means to address revenue shortfalls.

Further measures to address phoenix activities should primarily target those directors and persons who engage in the practice. Ordinary businesses, many of whom are "mums and dads" never intend to phoenix and should not be penalised merely because at some point their business might fail.

For example, the extension of the director penalty regime for unpaid goods and services taxes (GST) is a measure targeted to all companies, not just those engaged in wrongdoing. It will unnecessarily add to the day-to-day risks of running a small company.

The proposal that enables the Australian Tax Office (ATO) to require security for not only current but future (unknown) tax liabilities may potentially lock up working capital and impede investment and innovation in start-ups.

Both the Commissioner of Taxation and the ATO have broad and extensive asset and debt recovery powers. New laws should not be a substitute for better resourcing and better use of these current powers.

In HIA's submission, a more appropriate measure would be the introduction of a statutory definition of phoenix behaviour. This would provide directors with clarity and improved certainty on what conduct is captured.

These matters are elaborated on below.

2. GENERAL COMMENTS

2.1 THE BENEFITS OF THE CORPORATE FORM

It is a fundamental principle of company law in Australia (and elsewhere) that a company is a separate legal person, independent of its directors and shareholders. A company is responsible for its own debts and liabilities.

These basic principles are one of the reasons why the corporate form is favoured for the conduct of commercial enterprise. It enables much of the entrepreneurship, investment and innovation that facilitates economic growth.

Incorporation means an investor can share in the profits of an enterprise without being involved in its management. It provides structures for joint ventures; continuing trusteeship; fund management; and, the co-enjoyment of property.

Importantly, incorporation enables a business to carry on with a perpetual existence. It is not dependent on the life of the owner/manager. Even if the shareholders, directors, and officers come and go, the corporation carries on. This permanency means that management can make long-term decisions for the business. Investors also have a better chance to see a return on their money. The majority of companies are established with a view to this permanency.

In the residential building industry, the corporate structure is adopted by many businesses as this is the best way to enable management of the various business functions from general and financial administration to sales, marketing, ordering, design and occupational health and safety.

Despite incorporation being a popular business structure, many small residential builders and contractors still continue to operate as sole traders and do not want to spend the time or the money it would take to create a separate business entity. Incorporation carries increased paperwork and accounting costs that are considered too burdensome.

The outcomes of this consultation need to take into account the existing regulatory burden and obligations of company directors and officers into account.

2.2 PHOENIXING AND THE RESIDENTIAL CONSTRUCTION SECTOR

HIA notes that the construction industry is a focus for much of the commentary on measures to combat illegal phoenixing.

According to ASIC the “construction” industry appears largely represented in the overall number of insolvencies across the economy.

It should however be recognised that the construction industry is not homogenous.

The industry is divided amongst those businesses operating in detached residential, multi-residential, renovation, commercial, public infrastructure and civil works sectors. There are also a range of different categories of business and practitioner - from property developers and joint venture capital investors to commercial head contractors, builders, subcontractors and consultants.

Adopting a corporate structure is regarded as an appropriate risk management strategy to respond to project and business risks.

During a project, the first risk that threatens solvency is financial. Cost overruns can result from a number of reasons including poor estimating, under-budgeting, overly optimistic pricing or cut price tendering, poor coordination between design professionals and the trades, delayed project stage payments, and changing client demands.

The second risk relates to time. Time overruns (and delayed payments) can have devastating financial consequences for businesses in the construction industry.

The final risk relates to the design of the building. There is a risk that the completed building will not meet the owner's needs.

After the construction phase, ongoing responsibility for defects and warranties is a key risk.

Some businesses manage these risks by using asset-poor, project specific companies.

HIA does not seek to discount phoenix behaviour when it occurs, however it is important to recognise that these project specific vehicles are not as commonly used in the detached housing sector of the construction industry as they may be in other sectors.

HIA rarely comes across residential builders who deliberately sabotage the solvency of their business.

In HIA's experience, some companies in the sector fail because of poor business administration while others collapses due to the actions of third parties, most notably non-payment.

There are elements of the regulatory framework that apply to residential (domestic) building work nationally, including the unique licensing and homeowners warranty insurance system, that reduce the ability for directors of residential building companies to utilise phoenix arrangements.

Firstly, in all states and territories builders need a builder's licence or registration to contract, sub-contract or advertise, to undertake residential building work.

As part of the licensing eligibility process, applicants are subject to strict financial and personal probity requirements. There are existing exclusions for bankrupts. Directors who have controlled an insolvent company may be automatically excluded or otherwise will fail the "fit and proper" person requirements.

In Western Australia, for instance, under the *Building Services (Registration) Act 2011*, a building company is strictly prohibited from trading without a nominated supervisor and risks significant fines for non-compliance.

Under Section 18, the WA Building Commission has the power to require an applicant or renewing practitioner to satisfy the Board about sufficient material and financial resources. The Commission also has inquisitorial powers to investigate a builder's activities, including financial competence.

There are also ineligible person provisions within this section that prohibit certain persons involved in previous company and business failures from taking part in the management and supervision of building work. Similar laws exist in all States and Territories.

The Queensland government also recently passed legislation to address phoenixing including broad exclusions of "shadow directors" and 'influential persons'.

Those who have been involved with failed 'construction companies' outside of Queensland are also expressly excluded from obtaining a licence.

Another defining feature of the residential building industry is the mandatory regime of builder's indemnity or Home Warranty Insurance (HWI). HWI operates in every jurisdiction except for Tasmania.

Since 2001, HWI schemes have been one of "last resort". This means that a consumer can access the benefit of the policy of insurance when the builder dies, disappears or is insolvent.

In New South Wales, there is also a fourth trigger that enables a consumer to claim on the policy of warranty insurance when a builder fails to comply with a monetary order issued by the Court or Tribunal.

The operation of mandatory HWI under which the insurer provides a completion guarantee to a home owner in the event of a builders' insolvency means that a builder's financial position is consistently monitored by their insurer.

Before granting eligibility, an insurer reviews a builder's business history and finances to assess their risk. Insurers impose an annual turnover limit on builders based on their assessment of the value of works that a builder can prudently undertake given their financial position.

In some circumstances, insurers require a financial security or deed of guarantee or indemnity of some form before granting eligibility.

These types of measures do not apply in other sectors of the construction industry and they should be recognised in considering any potential additional measures.

2.3 What is Illegal Phoenix Activity? Proposing a Definition

There is currently no definition of illegal phoenix activity in Australian legislation.

HIA understands that providing a definition has been a longstanding topic of debate, given the difficulties in arriving at a definition that does not capture legitimate businesses or alternatively enables exploitation of loopholes by potential phoenix operators.

The consultation paper once again has deferred from establishing a definition.

Nonetheless, HIA considers the time has come to provide greater certainty and a legal distinction between legitimate business restructures and potential illegal phoenixing activities.

The University of Melbourne's Helen Anderson has stated that legal phoenix activity covers situations where the previous controllers start another similar business, using a new company when their earlier company fails, usually in order to rescue its business. Illegal phoenix activity involves similar activities, but the intention is to exploit the corporate form to the detriment of unsecured creditors, including employees and tax authorities. The illegality here is generally because of a breach of directors' duties in failing to act properly in respect of the failed company and its creditors.

There is also the more sophisticated case of companies that adopt phoenix activity as a business model from the outset.

In devising a definition in 2012, the Fair Work Ombudsman recommended the following definition:

Phoenix activity be defined as the deliberate and systematic liquidation of a corporate trading entity which occurs with the fraudulent or illegal intention to:

- *avoid tax and other liabilities, such as employee entitlements, and*
- *continue the operation and profit taking of the business through another trading entity.*

HIA recommends such a definition as an appropriate starting point for any reform measures. The key distinction between fraudulent phoenix activity and the honest resurrection of a company is the intent with which the liquidation is undertaken.

3. RESPONSE TO SPECIFIC PROPOSALS

3.1 MEASURES SUPPORTED

HIA supports the following measures identified in the consultation paper:

(1) That there be a single "phoenix hotline" where intelligence can be obtained from the public and shared with all members of the Phoenix Taskforce.

(2) A phoenixing offence

In principle, HIA supports the establishment of a phoenix offence to specifically prohibit the transfer of property to defeat creditors.

According to the decision paper, the offence would be a similar claw back provision to section 121 of the *Bankruptcy Act*.

HIA agrees that a similar remedy should be available for Corporations although we do note that section 588FE of the *Corporations Act* already does already give liquidators powers with respect to "voidable transactions" - unfair preferences and uncommercial transactions.

As noted above, HIA recommends that a phoenix offence should be based on a statutory definition.

(3) Extending remedies to allow recovery of property transferred in those circumstances, wider rights to compensation and civil and criminal penalties.

HIA supports, in principle.

(4) Preventing directors back dating their resignation date by creating a rebuttable presumption that they were still a director up to the date of lodgement of the form (where the form is lodged more than 28 days after the alleged retirement).

HIA supports, in principle.

(5) Avoid companies being 'abandoned' by limiting the right of a sole director to resign from office without either first finding a replacement director or winding up the company's affairs.

HIA supports, in principle.

(6) Targeting high risk entities

In principle, HIA supports a different approach being applied to high-risk entities (HRE) and high-risk phoenix operators (HRPO).

However the tests for identifying both should be based on objective statutory criteria (perhaps set out in regulations).

HIA is concerned that the current proposal to give the ATO the power to make an administrative declaration that a person is a HRPO, exposes the person, the corporate entity and decision maker to potential inconsistent decisions, perceptions of bias and the absence of nature justice.

The ramifications of being declared as a HPRO are significant and such a declaration should be made by appropriately qualified and experienced people in a body independent of the ATO.

There should also be some capacity or criteria for a person to no longer considered be a HRPO or have their status reviewed.

(7) Director Identification Number (DIN)

While not included in the consultation paper, the Federal Government recently announced the possible introduction of director identification numbers.

Although further detail is required, in principle HIA supports the proposal.

The introduction of a mandatory DIN for all existing and new directors could assist regulators to identify and monitor individuals that are repeatedly involved in phoenixing and use multiple identities to mask detection.

3.2 MEASURES NOT SUPPORTED

3.2.1 Extending Directors penalty regime to unpaid GST

One of the key reform options outlined in the consultation paper includes amending the Director Penalty Regime to add liability for unpaid goods and services tax (GST).

The Director Penalty Regime was introduced in 1993 to give the ATO power to make company directors personally liable for unpaid company taxation debts. It was originally limited to unpaid withholding tax for wages.

Section 269-15 of Schedule 1 to the *Taxation Administration Act* provides that the directors of the company (from time to time) on or after the initial day (the day when the company 'withholds an amount') must cause the company to comply with its obligation.

The director's obligation to cause the company to meet its obligation to pay a PAYG withholding or SGC liability commences from the time an amount is withheld or the end of the SGC quarter respectively.

This obligation continues until:
- the company complies with its obligation; or
- an administrator of the company is appointed under section 436A, 436B or 436C of the Corporations Act; or
- the company begins to be wound up.

According to the Explanatory Memorandum to the *Tax Laws Amendment (Transfer of Provisions) Bill 2010*:

> *"the penalty regime reflects the public duty on directors to ensure that amounts withheld from payments to third parties are promptly forwarded to the Commissioner. The public duty arises because withheld amounts are similar in nature to amounts held on trust. That is, the directors are in That is, the directors are in a position of trust and have a duty to protect those monies until they have been forwarded to the Commissioner."*

These rules can have a harsh application as the time allowed within which to arrive at an agreement with the Commissioner, appoint an administrator, or commence the winding up of the company is very short.

Although company directors are already at risk of being found personally liable for some tax debts of a company, HIA does not support the proposal to extend the regime to GST as well.

Unlike PAYG and superannuation, GST is an indirect broad based tax.

After 17 years, the basic operation of the tax may now be well known, but it is still quite a complex tax as it applies to certain transaction.

Under the GST laws, all prices and monetary consideration are treated as GST inclusive. The “supplier” is liable for GST on taxable supplies that it makes, however the supplier does not have a legislative right to charge an additional amount for GST to the recipient of its taxable supply. It becomes a contractual issue to ensure that a supplier can recover an additional amount in a position of trust and have a duty to protect those monies until they have been forwarded to the Commissioner.

Land sales, in particular real property transactions, have consistently given rise to complex and intricate GST issues for taxpayers.

Further for small businesses, the implications of accounting GST on either a cash or non-cash (accrual) basis may greatly affect the cash flow of their business, as GST is payable on sales for which payment has not yet been received. This can leave businesses substantially out of pocket, even if GST can also be claimed on unpaid expenses if you hold a tax invoice.

This type of proposal represents a fundamental overhaul to the personal liability of all directors, not just those involved in phoenix activity.

GST compliance is one of the largest sources of red tape burden for HIA’s members.

HIA notes that MYOB has estimated that the time lost to GST compliance for the approximate 2,000,000 small businesses in Australia equates to a productivity cost of $13.5 billion.

Adding the threat of personal lability for unpaid GST will further add to this burden.

3.2.2 Removing the 21 day waiting period for a Director’s Penalty Notice (DPN)

HIA notes the proposal to remove the 21 day notice period for issue of the DPN instead allowing the ATO to simply commence proceedings upon issue of the notice.

Although these measures are not targeted at every director but rather high risk entities HIA does not support this change.

The laws governing the director penalty regime were strengthened significantly in June 2012. As a result of these changes, it already is easier for directors to be held personally liable for debts set out in the notice. There is an automatic penalty. The ATO does not need to issue any notices or take any action to create the penalty. The only limit is that the ATO cannot commence proceedings to enforce directors’ personal liability until 21 days after service of a DPN.

21 days is already a very short period of time and given that the *Bankruptcy Act* already would allow such dispositions to be clawed back, HIA does not consider giving gives the ATO significant further powers is justified.

4. CONCLUSION

This is a difficult public policy area. HIA acknowledges that combatting illegal phoenixing requires a balance between devising mechanisms that capture those who abuse the corporate form without at the same time penalising directors who happen to be involved in a company that fails for various legitimate reasons.

Whilst HIA supports the further review of phoenixing, some of the reform measures proposed may not strike the right balance as they will penalise innocent directors, undermine the benefits of separate legal identities and distort the risk profile for small business.

Some of the current proposals do not reconcile with the Government's innovation agenda to encourage a culture of effective business restructuring, such as the recently passed laws introducing a safe harbour for directors.

In moving forward, tax and corporate regulators should make better use of their current powers.

HIA recommends that the Government consider a statutory definition of "phoenixing" to provide clarity and certainty for business and creditors.

HIA would be happy to assist Treasury further in relation to any of these matters.