

## **TAXATION - COMMON ISSUES FOR INSOLVENCY PRACTITIONERS**

**A paper presented by Helen Symon SC and Mark McKillop  
of the Victorian Bar<sup>1</sup>**

### **Introduction - Tax liability of a representative of an incapacitated entity**

1. The liability of insolvency practitioners to pay tax and to comply with administrative tax requirements seems to be a source of some confusion. From anecdotal accounts, industry practice may well have diverged from the requirements of taxation law.
2. The purpose of this paper is to highlight these key points:
  - (a) Insolvency practitioners are required to ensure that the entities to which they are appointed comply with most common tax obligations;
  - (b) although the entities to which they are appointed are legally separate, insolvency practitioners can be personally liable, under some circumstances, for the payment of post appointment tax liabilities of the insolvent entity: income tax, capital gains tax, PAYG collections and GST;
  - (c) choice of the type of appointment may affect the practitioner's personal liability to pay capital gains tax liabilities of the appointee and, accordingly, the assets available to the secured creditor.
3. In the eyes of the law an insolvency practitioner and the entity to which they are appointed are legally separate.
4. Australian income tax legislation also distinguishes between an insolvency practitioner and the relevant entity to which they are appointed. As a consequence, the tax debts incurred during an insolvent administration will be debts of the entity and not the practitioner, who remains legally separate.

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<sup>1</sup> Helen Symon SC is a Senior Counsel at the Victorian Bar specialising in taxation and insolvency. Helen's profile is available at <http://www.vicbar.com.au/c.1.3.aspx?RollNumber=1884>. Mark McKillop has been a junior barrister at the Victorian Bar since 2008 specialising in insolvency, banking and taxation. Mark's profile is available at <http://www.vicbar.com.au/c.1.3.aspx?RollNumber=4135>.

5. However, in order to protect the tax revenue, amendments to the compliance and administration provisions of tax legislation have imposed responsibility on practitioners for an entities' post appointment tax liability in many circumstances.
6. Accordingly, insolvency practitioners are required to ensure that the entities to which they are appointed comply with their income tax and CGT obligations, including filing tax returns, retaining funds to ensure the entity pays its income tax liabilities and remitting the tax. Importantly, the provisions include penalties which can impose personal liability on the practitioner for the relevant tax.

### **Taxation Administration Act 1953 (TAA) Subdivisions 260-B and 260-C**

7. Subdivisions 260-B and 260-C of the TAA impose specific obligations on liquidators and receivers (respectively).
8. In both instances, the practitioner must give the Commissioner written notice of becoming a liquidator or taking possession of the assets, as the case may be.
9. The Commissioner may then notify of any outstanding tax-related liabilities the company has when the notice is given:-
  - (a) tax-related liabilities include all liabilities for income tax, GST, fringe benefits tax, penalties and a general interest charge. In this respect see the table under s 250-10 and s 255-1;
  - (b) tax-related liabilities do not include a superannuation guarantee charge, in the case of a liquidator: s 260-40
10. Pending receipt of the Commissioner's notice, the liquidator or receiver may only part with the company's assets to pay, broadly, secured or other priority debts.
11. If the Commissioner gives notice, the liquidator must set aside, out of the assets available for paying the ordinary debts (tax liabilities, unsecured and other debts without priority) assets with a value calculated according to a formula which basically yields the *pari passu* share of the notified tax liabilities to the remaining assets.
12. The liquidator or receiver is charged with the liability to discharge the outstanding tax related liabilities to the extent of those assets.

13. Importantly, the liquidator or receiver is personally liable to discharge the tax-related liabilities to the extent of the calculated value and may be charged with an offence for failure to comply with the requirements of the section.
14. These sections preserve the position of the Revenue vis a vis identified tax liabilities of the company arising before appointment of the receiver or liquidator.
15. They specifically provide that they do not reduce any obligation or liability of a liquidator arising elsewhere. Accordingly, specific provisions of the *Income Tax Assessment Act 1936* (**the 1936 Act**) and the *A New Tax System (Goods and Services) Tax Act 1999* (**GST Act**) are not disturbed.

### **Section 254 of the 1936 Act imposes obligations on agents and trustees**

16. For the purposes of s 254, the definition of *trustee* includes an administrator, receiver or liquidator. See s 6(1) of the 1936 Act.
17. A voluntary administrator is an agent of the company, by *Corporations Act 2001*, s 437B.
18. A controller appointed under a charge or a mortgage is not an agent or trustee of the company. The usual terms of appointment appoint a controller as agent of the chargee or mortgagee: *Chant v DCT* (1994) 15 ASCR 184.
19. The obligations imposed by s 254 are:-
  - (a) generally, the agent or trustee *shall be answerable as taxpayer for the doing of all such things as are required to be done by virtue of this Act in respect of the income, or any profits or gains of a capital nature, derived by him in his representative capacity, or derived by the principal by virtue of his agency, and for the payment of tax thereon: s254(1)(a);*
  - (b) specifically:
    - (i) to make returns and be assessed thereon, in his representative capacity: s 254(1)(b);
    - (ii) to retain from time to time out of any money which comes to him in his *representative* capacity so much as is sufficient to pay tax which is or will become due in respect of the income, profits or gains: s 254(1)(d);

- (iii) payment of the tax on the income, profits *or gains* so derived: first, by paragraph (d), the agent or trustee is authorised and required *to retain from time to time out of any money which comes to him in his representative capacity so much as is sufficient to pay tax which is or will become due in respect of the income, profits or gains*. Second, by paragraph (e) the agent or trustee is made personally liable for the tax payable to the extent of any amount retained or which should have been retained.

20. Section 254, then, preserves the position of the Revenue vis a vis tax liabilities which arise following appointment of a liquidator, receiver or administrator.
21. Recent authority describes the personal liability as imposed by s254(1)(e) where the agent or trustee fails to retain money which comes to the agent or trustee after the making of an assessment or after the due date for lodging a return: *Barkworth Olives Management Ltd v DCT*<sup>2</sup> and see *Bluebottle UK Ltd v DCT*<sup>3</sup>. The reading of the subsection in those cases is narrower than literal, the language requiring the setting aside of funds to pay tax which *will become due*. The distinction made may have little impact in practice. We note that the distinction stems from fundamental authority that a tax debt does not arise until the amount of the tax liability is ascertained. Generally, under our self-assessment regime, that date is the due date for lodging of a return: s 166A, 1936 Act.
22. Casting personal liability on the liquidator or receiver or administrator ensures the tax liabilities are met before funds are applied to satisfy creditors.
23. We note, finally, paragraph (f) which appears to be a curious form of statutory *indemnity*. *The paragraph, presumably, means that the agent or trustee is entitled to be indemnified out of the assets of the company.*

#### *Section 254 and Capital Gains Tax*

24. Section 254 has particular implications in relation to capital gains tax which might become payable on realisation of an asset by a liquidator, receiver or administrator.
25. In the context of capital gains, we note:

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<sup>2</sup> [2010] QCA 80 at [29]

<sup>3</sup> (2007) 232 CLR 598. The decision in *Bluebottle* concerns parallel provisions in s255 of the 1936 Act dealing with persons having control of a non resident's income.

- (a) s 106-35 of the *Income Tax Assessment Act 1997* (the 1997 Act) which provides that an act done by a liquidator is treated as the act of the company. The provision is, possibly unnecessary in light of the common law position, summarised in *DCT v PM Developments Pty Ltd*<sup>4</sup>;
  - (b) s 106-60 of the 1997 Act which treats an act of an entity or its agent in enforcing or giving effect to security as the act of the entity who gave the security. Accordingly, the liability remains that of the company but s 254 of the 1936 Act shifts the liability to pay on to a liquidator, receiver or administrator. The Commissioner, again, gets effective priority for tax liabilities incurred by the company during the insolvent administration. The legislation ensures that tax is remitted before other creditors are satisfied. The presence of s 254 requires care in remitting proceeds of sale subject to capital gains tax to a security holder:-
    - (i) first, determine whether capital gains tax might be payable. In this respect, determination of the cost base of the asset may well be complicated by a lack of records;
    - (ii) determine the extent to which any liability might be offset by existing capital losses.
26. Section 254 may not have the same consequence in respect of a controller who is agent for a charge holder or mortgagee:-
- (a) s 106-60 retains the liability to pay tax in the company;
  - (b) the controller is not the agent or trustee of the company and so is not charged by s 254 with the obligation of satisfying the company's tax obligation. When a mortgagee exercises its powers of realising its security, the funds received are the property of the mortgagee not the property of the company: *Chant v DCT* (1994) 15 ACSR 184 at 188-189.
27. This analysis suggests that where:-
- (a) a company may make a capital gain on realisation of assets; and
  - (b) the company may not have capital losses which offset any such gain –
- a security holder might be advantaged by appointing an agent in possession to conduct the sale.
28. In our view, however, the Commissioner may well want to test the analysis and the proposition relied on in *Chant*.

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<sup>4</sup> (2008) 173 FCR 247 at [29]-[30]

## Other matters

29. We note, finally, *DCT v Tideturn Pty Ltd*<sup>5</sup>. This case indicates that liabilities may arise outside the tax legislation. There, a liquidator permitted a company to trade on. Group tax deductions were not remitted. There were, in the end insufficient funds to pay the company's debts.
30. On the liquidator's application for release, the Commissioner objected and sought recovery from the liquidator. The Court agreed that:-
- (a) the legislation imposed a clear obligation on the company to remit group tax deductions (at [11]-[12]);
  - (b) the failure to remit gave rise to a priority post liquidation debt payable in the liquidation as a priority payment under s 556(1)(a) of the (then) *Corporations Law* (at [13]);
  - (c) whilst expressing some sympathy for the liquidator the Court ordered him to pay, personally, \$75,000 as a condition of his release, after taking into account mitigating factors.
31. In preparing tax returns, we note two matters with respect to deductions:-
- (a) certain expenses of a liquidation can be claimed as deductions. For example, certain capital expenditure that is otherwise deductible over five years of trading may be deducted in the year of income. See s 40-880 of the *Income Tax Assessment Act 1997*;
  - (b) generally, care must be taken in claiming deductions. Expenses incurred are not deductible if the company has ceased to carry on business. Whether it has done so is as matter of fact. We refer to *FCT v Unilever at Australia Securities Limited* <sup>6</sup> per Hill, J. and cases referred to therein.

## GST and Incapacitated Entities

32. Division 58 of *A New Tax System (Goods and Services Tax) Act 1999* (**GST Act**) imposes personal liability to pay GST on a *representative* of an *incapacitated entity*.
33. Division 58 was introduced by the *Tax Laws Amendment (2009 Measures No. 5) Act 2009* (**the Act**) with retrospective effect to the introduction of the GST on 1 July 2000.
34. Section 58-10 is the critical provision. It provides, in relation to the payment of GST:

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<sup>5</sup> (2001) 37 ACSR 152.

<sup>6</sup> (1995) 56 FCR 152

(1) A *\*representative of an \*incapacitated entity*:

(a) *is liable to pay any GST that the incapacitated entity would, but for this section or section 48-40, be liable to pay on a \*taxable supply or a \*taxable importation; ...*

...

....

*to the extent that the making of the supply, importation or acquisition to which the GST ... relates is within the scope of the representative's responsibility or authority for managing the incapacitated entity's affairs.*

35. Section 58-20 requires the representative to be registered in the capacity of representative of the incapacitated entity if the incapacitated entity is registered or required to be registered.
36. Whilst s 58-10(1) imposes liability on the representative, s 58-10(5) specifically provides that the incapacitated entity is not liable to pay GST *to the extent that a \*representative of the incapacitated entity is liable under this section to pay the GST ....*
37. Both ss 58-10(1) and (5) apply, correspondingly, to entitlements to input tax credits and adjustments.
38. The closing words to s 58-10(1) carve out the area of the representative's responsibility. They impose liability on the representative in respect of supplies, acquisitions and importations which otherwise, by s 58-5, remain supplies, acquisitions and importations of the incapacitated entity itself. Accordingly, the Division provides for the GST regime to continue to apply to the incapacitated entity while imposing liability to pay on the entity's representative.
39. Section 58-5 is really only operative in relation to bankruptcy and other instances where the property of the incapacitated entity is vested in the representative. In the case of liquidators and receivers, who are agents of the company in any event, there is no need to separately provide that their supplies, acquisitions and imports are those of the company. In this regard, we note particularly *Deputy Commissioner of Taxation v PM Developments Pty Ltd* (2008) 173 FCR 247 which prompted the introduction of the Division and, in particular, the explicit imposition on the representative of the liability to pay the GST regardless of who might be said to have made the supply.
40. The legislation catches anyone who might be appointed to manage the property or affairs of the company. Section 195-1 defines *incapacitated entity* to be:

- (a) *an individual who is a bankrupt; or*
- (b) *an entity that is in liquidation or receivership; or*
- (c) *an entity that has a \*representative –*

whilst *representative* means:

- (a) *a trustee in bankruptcy; or*
- (b) *a \*liquidator; or*
- (c) *a receiver; or*
- (ca) *a controller (within the meaning of section 9 of the Corporations Act 2001); or*
- (d) *an administrator appointed to an entity under Division 2 of Part 5.3A of the Corporations Act 2001; or*
- (e) *a person appointed, or authorized under and \*Australian law to manage the affairs of an entity because it is unable to pay all its debts as and when they become due and payable; or*
- (f) *an administrator of a deed of company arrangement executed by the entity.*

41. Critically, the definition of representative now includes a controller. That overcomes the limitation of the catch-all in (e) which previously caught only persons appointed because an entity was insolvent. A controller is likely to be appointed to manage affairs of an entity before it becomes insolvent, because of the risk that the entity will become insolvent.

42. The representative's liability to pay the GST requires consideration of whether and to what extent, the making of a supply, acquisition or importation *is within the scope of the representative's responsibility or authority for managing the incapacitated entity's affairs.*

43. The Explanatory Memorandum to the Act contains some examples in this respect:

***Example 1.1 : Representative continues an existing lease under a new agreement***

*In August LeaseCo Pty Ltd enters into a two-year agreement to lease commercial premises to a tenant. Prior to December, when a receiver is appointed with respect to the premises subject to a lease, LeaseCo Pty Ltd invoices and receives payment from the tenant for the previous four months rent [sic] at \$1,100 per month.*

*The receiver notifies the tenant of their appointment and negotiates the continuation of the lease under a new agreement. Pursuant to subsection 58-10(1) the receiver is liable for the GST applicable to the supply of the premises under the new lease agreement.*

*The incapacitated entity remains liable for \$400 GST, being the GST applicable to the supply of the premises for the four months prior to the representative's appointment. The supply of the premises for the period prior to the representative's appointment is not within the scope of the representative's responsibility or authority for managing LeaseCo Pty Ltd's affairs.*



44. The example, as given, has a clear outcome because the receiver negotiates a new lease. If the premises simply continue to be supplied as required by the agreement to lease, however, the example may have different outcomes according to the scope of the receiver's appointment. The making of the supply might be said to be within the wide responsibility and authority given to a receiver appointed pursuant to a fixed and floating charge who would, as a consequence, be liable to pay the GST on it. The supply might not be within the scope of the responsibility and authority given a receiver under a narrower appointment, especially one that does not cover the leased property. Although a receiver in those circumstances might avoid personal liability, obligations would, nevertheless, arise under s 58-60, discussed below.

***Example 1.2 : Concurrent representatives***

*A receiver is appointed with respect to a commercial property from which JimCo Pty Ltd operates a printing business. The receiver is appointed with respect to the property to protect the interests of a secured creditor. At the same time a liquidator is separately appointed to wind up JimCo Pty Ltd.*

*With the acquiescence of the liquidator, the receiver enters into a contract of sale and sells the property with respect to which they were appointed. The receiver will be liable for the GST liability arising on the sale of the property, as the sale is within the scope of responsibility or authority of the receiver's appointment.*

*The liquidator will not be liable for any GST pertaining to the sale of the property, as the sale of the property is not within the scope of the liquidator's responsibility or authority.*

45. In the second example, both the liquidator and the receiver might be said to be liable for the incapacitated entity's supply. The making of the supply, namely the sale of the property is, strictly, within the responsibility and authority of both. The writer of the example appears to have ascribed the personal liability only to the receiver on the basis that it is the receiver that has made the supply as representative of the incapacitated entity.
46. It is also important to be aware of ss 58-60 and 58-50 which are, to some extent, complementary.
47. Section 58-60 imposes an obligation to notify the Commissioner of an amount of GST for which the entity is liable if:
- (a) *the representative becomes aware, or could reasonably be expected to have become aware, of the amount of GST ... ; and*
  - (b) *the amount of GST ... has not been taken into account in any \*GST return that has been given to the Commissioner; and*

(c) *the Commissioner has not been previously notified of the amount of GST ... under this section.*

48. The obligation is imposed on a representative who has the capacity to declare dividends to unsecured creditors and must be given before the day the representative declares a dividend. It is important to be aware of that obligation because a representative is liable to an administrative penalty if it is not complied with.
49. Section 58-50 gives the Commissioner power to direct a representative to furnish a GST return for a tax period if the entity has failed to do so. Section 58-50(4) requires the Commissioner to consider the appropriateness of such a direction in all the circumstances of the incapacitated entity. He is required to take into account the following matters:
- (a) *the likelihood of a dividend to unsecured creditors of the \*incapacitated entity being declared, and the likely amounts of any such dividend; and*
  - (b) *the likelihood that, if the Commissioner were given the \*GST return, it would reveal a liability to pay an amount to the Commissioner under the \*GST law; and*
  - (c) *the availability of books and records that would make it possible to prepare the GST return; and*
  - (d) *the likelihood that the cost to the \*representative of preparing the GST return would be covered by the incapacitated entity's assets without resulting in an unreasonable impact on the other creditors of the incapacitated entity.*
50. Note further, that, as well as circumscribing the Commissioner's power by the factors outlined above, a decision by the Commissioner to direct the furnishing of a GST return is a reviewable GST decision under the *Taxation Administration Act 1953* and, thus, may be the subject of an objection. The option to invoke the objection and review procedures might be used where furnishing requested returns is considered oppressive in the circumstances.

**Conclusion**

Practitioners need to be aware that, in effect, they will be liable either directly or under penalty provisions for CGT, income tax and GST applying to the entity to which they are appointed. They are also required to ensure that administrative requirements, such as filing returns, are completed. Accordingly prudent practice requires withholding sufficient funds to cover the liabilities until they are paid.

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Helen Symon SC  
Melbourne Chambers  
Contact 9640 3174

Mark A J McKillop  
Dawson Chambers  
Contact 9229 5032