# WHO WANTS TO BE A DIRECTOR?

## COMPANY DIRECTORS, UNPAID TAX AND PERSONAL LIABILITY

Recent amendments to the director penalty regime have raised the tax-compliance burden for company directors to new levels. **By Simon Tisher**

The primary basis for the amendments to the director penalty (DP) regime is to stamp out fraudulent "phoenix" activity; that is, where a company's tax debts are unpaid, and the company is liquidated and then re-emerges, with the same officers, under a different name. However, the amendments are broader than this.

Generally the amendments apply from 30 June 2012. However some of the measures apply to amounts that have accrued and which are outstanding as at 30 June 2012. In this way, some amendments are essentially retrospective in operation. To minimise the risk of potential personal liability, directors will need strict governance to ensure that their company appropriately meets its tax obligations.

## Background

For many years, the Commissioner of Taxation took priority over other creditors for certain unremitted amounts in insolvency or bankruptcy matters.[1] The most common amounts that were subject to the Commissioner's priority were tax instalment deductions from salary or wages under the former PAYE regime and deductions made under the prescribed payments system. Recovery of such amounts from directors proved to be a time consuming process.

In 1993, the Commissioner's priority was removed.[2] One reason for this was the perception that there was insufficient impetus to compel directors to cause companies to comply with their remittance obligations at the time they were due. The Commissioner's priority could also prejudice other creditors.

The same legislation that removed the Commissioner's priority introduced a DP regime in 1993. It was stated that this would allow the Commissioner to take "more effective recovery action" for unremitted amounts from directors.[3] It would also allow the Commissioner to estimate amounts payable and to commence recovery action on the basis of that estimate.

The DP regime was originally contained in Division 9 of Part VI of the *Income Tax Assessment Act* 1936 (Cth) (*ITAA*36). In 2010, the DP provisions in Division 9 were repealed and rewritten into Schedule 1 to the *Taxation Administration Act* 1953 (Cth) (*TAA*).[4] Subject to transitional rules, the rewritten provisions were effective from 1 July 2010.[5]

## Operation of the DP regime

The object of the DP regime is to place the directors of a company under a duty to ensure that a company either meets its remittance obligations under subdivision 16-B of Schedule 1 to the *TAA* or goes promptly into voluntary administration or liquidation (ss269-1 and 269-5 of Schedule 1 to the *TAA*). These duties on directors are enforced by penalties.

Fundamentally, the DP regime seeks to impose, and enforce, the company's remittance obligations for PAYG and other withholding taxes onto its directors from the date that the company withholds the amount(s) that is to be paid to the Commissioner (i.e. not necessarily from the date it is due to be paid to the Commissioner).[6]

The DP regime imposes an obligation on directors to cause the company to comply with its remittance obligations until one of the following occurs:

- the company pays the unremitted amount to the Commissioner;
- an administrator of the company is appointed (pursuant to ss436A, 436B or 436C of the *Corporations Act* 2001 (Cth)); or
- the company begins to be wound up (within the meaning of the *Corporations Act*).

The Commissioner cannot take any step to recover a penalty if an arrangement to pay a tax liability by instalments is in force pursuant to s255-15 of Schedule 1 to the *TAA*.[7] However, this does not prevent the Commissioner from giving a director a DP notice.

### Breach of the obligation

A failure by the company to comply with one of the three options above by the date that the withholding is due to be paid to

ILLUSTRATION **CHRISTOPHER NIELSEN**

The amendments . . . expand the DP regime to make directors personally liable for a company's unpaid SGC.

the Commissioner results in each director becoming liable to a penalty for the unremitted amount(s). Note that liability is imposed on all persons who were directors for any of the period from when the company withheld the amount(s) to when it was due to be paid.

However, the Commissioner must not commence proceedings to recover the penalty from a director until 21 days after the Commissioner gives the director(s) a notice pursuant to s269-25 of Schedule 1 to the *TAA*. The notice must:

- set out the unpaid amount owing by the company;
- state that the director is liable to pay the unpaid amount; and
- explain the main circumstances in which the penalty will be remitted.

With some exceptions (below), the penalty imposed on directors is remitted if one of the three options above occurs before the notice is given by the Commissioner or within 21 days (14 days prior to 2010) after notice of the penalty is given by the Commissioner (s269-30).

Newly appointed directors are dealt with separately (below).

### DP notices and service

DP notices can list several amounts owing on the one notice. The notice may be given by leaving it at or posting it to an address that appears from information held by the Australian Securities and Investments Commission to have been, within the last seven days, the director's place of residence or business (s269-50).

Service of the notice has been frequently disputed in recovery proceedings. One particular area of conjecture was whether a DP notice was "given" on the date it was sent by post on the one hand or on the date of delivery on the other. Pursuant to the 2010 rewrite, the notice period is taken to commence when the Commissioner posts the notice or leaves it at the director's place of residence or business (s269-25(4); this is despite s29 of the *Acts Interpretation Act* 1901 (Cth)).

### Defences

Pursuant to s269-35 of Schedule 1 to the *TAA*, a director is not liable to a penalty if they can establish that:

- because of illness or for some other good reason it would have been unreasonable for the director to take part (and the director did not take part) in the management of the company at any time when the person was a director and the directors were under the obligations referred to above; or
- the director took all reasonable steps to ensure that the directors caused the company to comply with its obligations or there were no such reasonable steps the director could have taken.[8]

Reliance on the defences is a difficult prospect since they have been construed narrowly by the courts.[9] An additional defence is now available in relation to a penalty arising from the non-payment of the superannuation guarantee charge (SGC) (see below).

### Indemnity and contribution

Penalties imposed by the regime operate as parallel liabilities. This means that a penalty is imposed on each director who was under the obligation discussed above. If a liability is discharged by a director in whole or part by payment to the Commissioner, each of the other liabilities imposed on other directors is reduced to the same extent (s269-40(2) of Schedule 1 to the *TAA*). The regime provides directors who pay penalties under the DP regime with rights of indemnity, subrogation, contribution or otherwise.

## Expansion of the DP regime

### Recent amendments

Three substantive amendments to the DP regime were enacted by the *Tax Laws Amendments (2012 Measures No. 2) Act* 2012 (Cth). The amendments do the following:

- expand the DP regime to make directors personally liable for a company's unpaid SGC (including estimates of such SGC);
- ensure that directors cannot discharge their obligations by placing the company into administration or liquidation when PAYG withholding or superannuation guarantee (SG) amounts remain unpaid and unreported three months after the due date; and
- in some instances make directors and their associates liable to PAYG withholding non-compliance tax where the company has failed to pay amounts withheld to the Commissioner.

Other minor amendments were also made (below).

### 1. Superannuation guarantee

The DP regime has now been extended to impose liability on directors for their company's unpaid SGC.

Pursuant to the *Superannuation Guarantee (Administration) Act* 1992 (Cth) (*SGAA*), where an employer fails to pay the appropriate amount of SG contributions on behalf of their employees within 28 days of a quarter ending, an SG shortfall arises for the outstanding amount. The SGC is equal to the SG shortfall for a given quarter.

For the purposes of the DP regime, a company's SGC is treated as payable on the day the company is required to lodge its SG statement (disclosing an SG shortfall) for the quarter with the Commissioner (or such later day as the Commissioner permits) (s33 of the *SGAA* and s269-10(3) of Schedule 1 to the *TAA*). This is the case even if the SGC has not been assessed. The date that the SG statement is typically due is the 28th day of the second month of the following quarter (unless a later date has been granted by the Commissioner. The rationale behind this is to avoid the scenario of directors escaping liability by failing to lodge the relevant SG statement.[10]

The extension of the DP regime applies to an SG statement for a quarter that must be lodged on or after 30 June 2012.[11]

In circumstances where the SGC has not been assessed by the Commissioner, or where an SG statement has not been lodged by the employer, the Commissioner may issue an estimate to the employer of the unpaid and overdue amount of SGC. The issuing of an estimate creates a separate liability from the underlying SGC liability. Payment of the estimate discharges the underlying liability and vice-versa, to the extent of the payment (s268-20 of Schedule 1 to the *TAA*). The estimate may be reduced or revoked if a director submits a statutory declaration or affidavit pertaining to various matters (s268-90(2A)). A DP will arise from the non-payment of an estimate of SGC (ss268-10(1), 268-10(1A) and 269-10).

The defences outlined above will apply to DPs issued in respect of unpaid SGC. In

addition, a director is not liable to a DP relating to SGC if they can establish that:

1. the penalty resulted from the company treating the *SGAA* as applying to a matter in a particular way that was reasonably arguable; and
2. the company took reasonable care in connection with applying the *SGAA* to the matter (s269-35(3A) of Schedule 1 to the *TAA*).

A matter is reasonably arguable if: "it would be concluded in the circumstances having regard to relevant authorities that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect".[12] According to the explanatory memorandum, exercising reasonable care means making a reasonable attempt to comply with the relevant law.[13]

## 2. Discharging unpaid and unreported liabilities three months after the due date

Ordinarily, the Commissioner must give the director a DP notice and wait at least 21 days before commencing recovery. An important exception to this requirement now exists for liabilities, including SGC, that remain unpaid and unreported for at least three months from the due date. In that scenario, directors who place their company into administration or liquidation will remain personally liable for the liability of the company.

The intention of this measure is to target phoenix operators; the 21-day requirement resulted in some phoenix operators extinguishing their potential personal liabilities by placing the company into administration or liquidation. Where the tax liabilities are at least three months old, and are unreported and unpaid, this will no longer be an option.

Importantly, this measure applies to unpaid and unreported amounts that are outstanding as at 30 June 2012 (but which accrued before that time). That is, if a director is liable to a penalty before 30 June 2012 which is not remitted by that time, the three-month rule will apply (the Commissioner will still need to give the director a DP notice to recover the amount).

New directors (appointed after the due date) will not be subject to the three-month rule until three months after they become a director of a company, even if the liability of the company is more than three months old. This heightens the need for new directors to perform a tax due diligence on the prior tax payment profile of their company.

The implications of the new "three-month" rule are considerable. Often three months will have elapsed before the Commissioner issues a DP notice. In this scenario, where the liabilities are unpaid and unreported, directors will have to either cause the company to pay the liability or pay the liability personally.

The three-month rule applies only to tax that has been withheld that is both unpaid and unreported. A solution to avoiding the restrictions of the three-month rule is for the company or directors to report the liability within three months from the due date. In that case, DPs will be remitted if the company is placed into administration or liquidation after three months elapse (and within the time stipulated by a DP notice).

Arguments exist that the three-month rule is excessive. This is especially so given that the fundamental objective of the DP regime is to ensure that a company either complies with its remittance obligations on time or promptly goes into administration or liquidation. The three-month rule could result in more preference arguments being raised if

LOOKING FOR STANDOUT COLLEAGUES?...

... THEN ADVERTISE FOR FREE WITH THE COLLEGE OF LAW

**Need a law graduate, work experience student or recently admitted practitioner?**

The College's free online jobs noticeboard can get your job in front of thousands of PLT students and new lawyers across Australia.

See just how easy it is to advertise - visit us at www.collaw.edu.au/careers today!

Visit **www.collaw.edu.au**

THE COLLEGE OF LAW Victoria

The three-month rule could result in more preference arguments being raised if tax is paid by a company and the company is subsequently placed into administration.

tax is paid by a company and the company is subsequently placed into administration or is liquidated. In this regard, advice should be taken about a director's potential liability to indemnify the Commissioner pursuant to s588FGA of the *Corporations Act* if a company is likely to be wound up after it pays or proposes to pay to the Commissioner an amount of PAYG (or other amount caught by the DP regime). Alternatively, an increase in directors being bankrupted could result for those who fall foul of the three-month rule.[14]

### 3. Liability to PAYG withholding non-compliance tax

Ordinarily, employees and individuals who receive wages or fees from companies are entitled to a credit for tax withheld and paid to the Commissioner. A new PAYG withholding non-compliance tax is now applicable for amounts withheld on or after the income year commencing 1 July 2011 which were payable to the Commissioner on or after 30 June 2012.

The circumstances in which an individual must pay the PAYG withholding non-compliance tax is set out in Division 18 of Schedule 1 to the *TAA*. Liability is imposed on company directors and their associates where:

i) their company was required to pay to the Commissioner amounts withheld from payments made to any entity; and
ii) the company does not pay the amounts to the Commissioner by the due date (see s16-70 of Schedule 1 to the *TAA*); and
iii) the director or associate is entitled to a credit that is attributable to amounts withheld from withholding payments made to that individual.

The amount of tax payable by the director or associate is the lesser of:

- the total amounts withheld from payments made to the individual by the company in the individual's income year; and
- the company's PAYG withholding liability for payments made during the income year.

Although liability to the tax arises in the circumstances set out above, the Commissioner cannot commence recovery proceedings against the director or associate unless a notice is issued to the director or associate (see s18-140 of Schedule 1 to the *TAA*). The Commissioner may only give the notice if he or she is satisfied that it is "fair and reasonable" for the individual to pay the tax in relation to the company for the income year (s18-140(2) of Schedule 1 to the *TAA*). The expression "fair and reasonable" is not defined. Further, the Commissioner cannot issue a notice where the director has a DP liability because of the company's failure to pay PAYG withholding for the income year (s18-140(3) of Schedule 1 to the *TAA*).

Where a notice is issued, the notice must specify the company, the income year and the amount of the tax the individual must pay. Time limits are applicable for the issuing of a notice (s18-185).

PAYG withholding non-compliance tax is due and payable at the same time as the original income tax must be paid by the individual for that financial year (s18-145).[15]

The Commissioner must (by written notice) reduce the amount of PAYG withholding non-compliance tax if he is satisfied that the director has successfully raised a defence (s18-130). The defences that exist mirror those applicable for the DP regime.

In some instances, associates of directors can be liable to PAYG withholding non-compliance tax. The term "associate" is broadly defined.[16] Several requirements must be met before an associate will be liable for PAYG withholding non-compliance tax; these are beyond the scope of this article.

A director or associate who receives a notice from the Commissioner in relation to the recovery of an amount of PAYG withholding non-compliance tax can object to any decision made by the Commissioner to reduce the amount of tax payable, issue a notice to enable recovery or entitle the individual to a credit (s18-190).

### Other amendments

New directors (appointed after 30 June 2012) will not become personally liable for unremitted amounts until 30 days after they become a director.

Further, for DPs that are due on or after 30 June 2012 (or before that time to the extent they are not paid, remitted or discharged before 30 June 2012) the Commissioner may serve a copy of a DP notice on the address of the registered tax agent of the director (if applicable) (s269-52 of Schedule 1 to the *TAA*).

## Conclusion

The prospect of a director being personally liable for the tax debts of a company is now greater than ever before. Although there is merit in seeking to reduce fraudulent phoenix activities that jeopardise the collection of revenue, real questions must now be asked about whether the original purpose of the DP regime has been compromised.

**SIMON TISHER** has been a barrister since May 2003. His main areas of practice are taxation, insolvency and commercial litigation. Since coming to the Bar, Simon has worked for and against the ATO.

**1**. See former ss221P, 221YHJ, 221YHZD and 221YU of the *Income Tax Assessment Act* 1936 (Cth).
**2**. *Insolvency (Tax Priorities) Legislation Amendment Act* 1993 (Cth).
**3**. Explanatory Memorandum to the *Insolvency (Tax Priorities) Legislation Amendment Act* 1993.
**4**. *Tax Laws Amendment (Transfer of Provisions) Act* 2010, Schedule 1, items 2 and 10.
**5**. Note 4 above, item 2, Schedule 1, Part 3, Divison 5, items 64 and 65.
**6**. These include alienated personal service payments, certain non-cash benefits and withholding tax in relation to certain employee share schemes. A notice of estimate given by the Commissioner in relation to most of the amounts above is also subject to the DP regime: see s269-10 of Schedule 1 to the *TAA* (and Divisions 12 and 13, Subdivisions 14-A, 14-B and 14-C and Division 268 of Schedule 1 to the *TAA*).
**7**. Section 269-15(3) of Schedule 1 to the *TAA*.
**8**. Note that the defences in s269-35 are similar to those contained in s588H of the *Corporations Act*, which contains defences to a contravention of s588G(2). This places a duty on directors to ensure their company does not trade while insolvent.
**9**. See for example *DCT v Pejkovic* [2000] NSWSC 1176, *DCT v George* [2002] NSWCA 336, *DCT v Saunig* [2002] NSWCA 390 and *DCT v Stenner* [2003] QDC 53.
**10**. Explanatory Memorandum, paragraphs 1.25–1.30.
**11**. Note that if an SGC amount is unpaid and unreported and is outstanding for three months from the due date, the director will not be able to avoid personal liability by putting the company into administration or liquidation.
**12**. Defined in s284-15 of Schedule 1 to the TAA. See also *Allen (Trustee), Re; Allen's Asphalt Staff Superannuation Fund v Commissioner of Taxation* (2011) 195 FCR 416; *Walstern Pty Ltd v Commissioner of Taxation* (2003) 138 FCR 1.
**13**. Explanatory Memorandum, paragraph 1.55.
**14**. K Walsh, "Stiff director penalties to deter talent", *Australian Financial Review*, 18 July 2012.
**15**. The individual is treated as being required to pay income tax for that year where no tax (except for the PAYG withholding non-compliance tax) would otherwise be payable.
**16**. It includes relatives, partners, a spouse and children of a natural-person director: s318 of the *ITAA*36.