THE LAW SOCIETY
OF NEW SOUTH WALES

Our Ref: MM:AW

Direct Line: 9926 0256

13 April, 2010

Mr Geoff Miller
General Manager
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Miller,

Re: ATO "garnishee notices"

The Business Law Committee of the Law Society ("Committee) has considered the powers of the Commissioner of Taxation under section 260-5 of Schedule 1 to the *Taxation Administration Act 1953 (Cth).* The Committee has raised the following concerns in regard to the section. This submission has not been reviewed by the Council of the Law Society and therefore the comments set out below are those of the Committee.

1. The issues – ATO "garnishee notices"

1.1 The Commissioner of Taxation, under section 260-5 of Schedule 1 to the *Taxation Administration Act* 1953 (Cth), has the power to issue notices (*notices*) to debtors of taxpayers, that require that the debtor pay to the Commissioner (rather than the taxpayer) the proceeds of the debt due to the taxpayer. Those notices are an evolution of the "section 218" notices that were previously able to be issued under section 218 of the *Taxation Administration Act* 1953 (Cth) before its substantial overhaul.

1.2 It has been widely held that notices of this kind create a "statutory charge" in favour of the Commissioner and the notices have been likened to a form of garnishee order (albeit without judicial intervention).

1.3 The recent high-profile decisions in *Re Octaviar Ltd (No 8)* [2009] QSC 202 and *Bruton Holdings Pty Ltd v Commissioner of Taxation* [2009] HCA 32 have made it clear that the Commissioner is increasingly turning to these notices as a means of obtaining an advantage in corporate insolvencies. This is particularly the case in the failure of large corporate groups, where it is easy to issue the notices to a number of solvent members of a corporate group in relation to the parent's tax debt - all manner of intercompany debts will be capable of being captured by the notice. The Commissioner also issues the notices to trading banks, with a view to emptying a company's bank debts, sometimes hours before the company enters into external administration.

For ease of reference, a more detailed discussion of the judicial approach to notices is set out in the Annexure to this letter.

2. Why this is a problem

2.1 That strategy (one that is open to the Commissioner, and one that the Law Society does not criticise) has regrettable consequences when it comes to attempts to implement corporate rescues. This is for a number of reasons:

(a) While the decision *Bruton Holdings* makes it clear that the Commissioner cannot effectively issue a notice in relation to a corporate taxpayer that is in liquidation, that does not entirely solve the problem.

(b) It is possible for the Commissioner to use the notices, even after a company has entered into voluntary administration under Part 5.3A of the *Corporations Act* 2001 (Cth), to improve his/her position in the insolvency. This is possible because:

(i) the stay and moratorium on claims against a company in administration (sections 440D and 440F of the *Corporations Act*) is not effective against the notices. See the definition of "enforcement process" in section 9 of the Corporations Act - clearly, the notices are not captured; and

(ii) in the event that a deed of company arrangement (DOCA) is entered into, the prohibition in section 468 of the Corporations Act on post-liquidation transfers of property will never come into effect. Accordingly, decisions such as *Macquarie Health Corporation v Commissioner of Taxation (1999) 96 FCR 238*, which held that a notice issued after administrators were appointed was invalidated in a subsequent winding up (because the winding up is deemed to have commenced when the administrators were appointed), will not be applicable.

Accordingly, any DOCA proposal will need to accommodate the Commissioner somehow.

(c) In addition, decisions such as *Re Octaviar Ltd* and *Brown v Brown* [2007] FCA 2073 make it apparent that there will be instances where, through judicial intervention in the administration process, the Commissioner is able to effectively issue notices under the *Taxation Administration Act* after the company has entered administration (or would have entered administration had it not been prevented from doing so, as was the case in *Re Octaviar Ltd*).

(d) The notices do not need to be registered with any publicly available information provider. That is, other creditors dealing with a taxpayer can not readily determine whether or not a taxpayer or its debtors have been served with a notice. This information is clearly relevant to the decisions of creditors as to whether or not to continue to extend credit to the taxpayer. That situation may be contrasted to the public availability of information about enforcement action being taken by other creditors (for example, judgment creditors or secured creditors).

(e) Finally, and perhaps most importantly, it has been established in *Macquarie Health Corporation* that the notices are not "transactions" for

the purposes of the voidable transaction provisions in Part 5.7B, Division 2 of the *Corporations Act*. That is, the notices cannot be set aside as an unfair preference if issued six months before the "relation-back day" for a particular company (at a time when the company was insolvent).

Contrast this to the position of ordinary unsecured creditors, and secured creditors who improve their security during the 6-month look-back window – in each instance, transactions with the insolvent company having the effect of improving the creditor's position will be capable of being set aside.

Further, consider the position of an unsecured creditor who has commenced its own form of execution against the insolvent company. Execution is itself rendered void by section 468(4) of the *Corporations Act* in so far as it is "put in force" after the commencement of the winding up. It has been held that where execution is levied on the company's goods under a writ of *fi fa*, the execution is "put in force" not when the writ is delivered to the sheriff, but only when the execution is actually levied, that is, when the goods are seized by the sheriff.[1] Contrast this to the position with notices issued by the Commissioner, which only need be issued on the taxpayer before the commencement of the winding up in order to be effective.

2.2 The last factor can greatly hamper corporate rescue efforts - the Commissioner is able to substantially improve his/her position in advance of a corporate failure, to the detriment of unsecured creditors (including priority creditors such as employees) and to creditors with floating charge security only (whose charges have not yet crystallized) - the holders of "featherweight" charges, with very limited crystallisation events, should be most concerned.

3. The policy position

3.1 All of this is against a background where the Commissioner lost his/her statutory priority for tax debts quite some time ago - policy has clearly shifted against the Commissioner being able to leap-frog ordinary unsecured creditors and, in particular, priority creditors such as employees and the insolvency practitioners themselves.

3.2 The Business Law Committee, however, is conscious that the continued availability of the notices to the Commissioner may be a factor in that compromise of the Commissioner's former priority – the notices enable the Commissioner to maintain a strong hand in corporate insolvencies.

3.3 Nonetheless, the Business Law Committee considers that the adverse effects of the notices on corporate rescue efforts, availability of funds for distribution to priority creditors in a winding up[2] and the value of security held by secured creditors holding floating charges only, merits a closer consideration of the legislation and policy surrounding the use of the notices by the Commissioner.

4. Options for reform

4.1 The Business Law Committee considers there are several options that should be considered in reforming the regime for issue of notices by the Commissioner:

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[1] *Re London & Devon Biscuit Co* (1871) LR 12 Eq 190; see also *McQuarrie v Jaques* (1954) 92 CLR 262; *Hall v Richards* (1961) 108 CLR 84

[2] In particular, employee entitlements and superannuation.

(a) Amend the *Corporations Act* to reverse the effect of the decision in *Macquarie Health Corporation* and enable notices to be set aside as unfair preferences if they are issued on a debtor to an insolvent taxpayer within the statutory look-back period.

(b) Develop a clear and publicly available policy governing the circumstances in which the Commissioner will issue notices and how he/she will use the rights attached to notices in the context of a corporate insolvency.

(c) Establish a publicly available register of companies that are the taxpayer in relation to whom notices have been served by the Commissioner.

(d) Amend the *Taxation Administration Act* to make the notices, if served within the six-month period before a taxpayer's insolvency, ineffective in the external administration (whether that be a voluntary administration, deed of company arrangement or liquidation).

4.2 Obviously, it would be premature of offer any views about the relative merits of those reforms; rather, the matter is something for consultation amongst the stakeholders affected by any proposed reform, including the Commissioner, insolvency practitioners, financiers, worker unions and tax professionals.

The Committee would be pleased to discuss with the Australian Taxation Office the potential for reform in this area. If you would like to make an appointment to progress the matter, please contact Andrew Wilson, Executive Member of the Business Law Committee on (02) 9926 0256 or by email to Andrew.wilson@lawsociety.com.au

Yours sincerely,

Mary Macken
President

Annexure

1. Some greater detail on the legislation and decided cases

1.1 As noted above, the power to issues notices of this kind is set out in section 260-5 of Schedule 1 to the *Taxation Administration Act*. That legislation relevantly provides as follows:

> *"(2) The Commissioner may give a written notice to an entity (the third party) under this section if the third party owes or may later owe money to the debtor.*
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> *(3)The third party is taken to owe money (the available money) to the debtor if the third party:*
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> *(a) is an entity by whom the money is due or accruing to the debtor; or*
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> *(b) holds the money for or on account of the debtor; or*
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> *(c) holds the money on account of some other entity for payment to the debtor; or*
>
> *(d) has authority from some other entity to pay the money to the debtor.*
>
> *(4)A notice under this section must:*
>
> *(a) require the third party to pay to the Commissioner the lesser of, or a specified amount not exceeding the lesser of:*
>
> *(i) the debt; or*
>
> *(ii) the available money; or*
>
> *(b) if there will be amounts of the available money from time to time—require the third party to pay to the Commissioner a specified amount, or a specified percentage, of each amount of the available money, until the debt is satisfied."*

1.2 Accordingly, a notice issued under that legislation has the effect of directing that a debtor of a taxpayer is directed, rather than paying money to the taxpayer in reduction of its indebtedness, make those payments to the ATO – the notice is similar to a garnishee order made by a Court.

1.3 The notice is a powerful tool for the Commissioner to gather in unpaid tax. Indeed, the language of the section seems sufficiently wide to even capture moneys held on trust for the taxpayer by a third party. The authorities on this issue, however, are not clear.[3]

2. The decided cases

2.1 There is now a substantial body of decided cases touching on the issue of validity of notices served by the Commissioner that are in the nature of the Notice. While

[3] Compare *Woodroffe v Deputy Commissioner of Taxation* (2000) 179 ALR 750, where the ATO successfully required payment to it of moneys held on trust by a solicitor for his taxpayer client, to *Permanent Trustee Co Ltd v University of Sydney* [1983] 1 NSWLR 578, where Helsham CJ in Eq determined that a notice was not effective in relation to a receipts under a trust of income.

the majority of those cases deal with notices served under the preceding version of section 260-5 of Schedule 1 to the *Taxation Administration Act*, being section 218 of the *Income Tax Assessment Act* 1936 (Cth), the wording of the new legislation is substantially similar to the old legislation and the Explanatory Memorandum published in relation to the new legislation makes it clear that the new legislation was not intended to render any changes to the then existing law.[4] In those circumstances, the older cases remain relevant.

2.2 The leading authority is the High Court's decision in *Clyne v Deputy Commissioner of Taxation*.[5] In that matter, the Commissioner served a notice of assessment on a taxpayer for unpaid tax. Subsequently, the Commissioner served on a bank two notices requiring it to pay to the Commissioner money kept on term deposit by the taxpayer with the bank. After service of the notices on the bank, the taxpayer, by deed, assigned the deposits to a third party as security for future advances to be made by the assignee to the taxpayer. The taxpayer gave notice of that assignment to the bank, and there was a dispute as to who was entitled to the deposits.

2.3 The Court determined that the Commissioner was entitled to succeed, but it is clear that this decision was predicated on the Commissioner's notice having been served *before* the assignment of the debts was effected.[6] It is clear from the judgments, however, that the Court did contemplate the possibility that an assignment of the debts before receipt of the Commissioner's notice would have been effective against the Commissioner.[7]

3. *Interaction with floating charges*

3.1 In *Tricontinental Corp Ltd v Federal Commissioner of Taxation*,[8] the Commissioner served a notice on two of the taxpayer's debtors in respect of outstanding income tax. A secured creditor with a floating charge over the book debts of the taxpayer later crystallised the floating charge by giving notice of default and appointing receivers. Like *Clyne*, the Full Court of the Supreme Court of Queensland held that the Commissioner was entitled to succeed against the secured creditor, but the Court made it clear that it considered that had the floating charge been crystallised prior to the Commissioner serving its notice then the matter would have been decided differently. Connolly J (Shepherdson J agreeing) observed that,[9]

> "*Whether in a case in which a charge, which, as in this case, is expressed to be a floating charge, has crystallised, that fact would be sufficient to defeat a notice under s218 of the Income Tax Assessment Act is, I think, not free from difficulty. In form at least the money is still due or accruing to the taxpayer. The debenture holder enforces his rights by appointing a receiver who would demand and recover the debt in the name of the taxpayer. If the analogy with forms of execution such as garnishment be appropriate, then it might well be right to say that s218 can only operate on the taxpayer's beneficial interest in the moneys. A more direct approach is to say that once a floating charge has crystallised, moneys*

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[4] See Explanatory Memorandum to the *A New Tax System (Tax Administration) Bill* 1999 (Cth) at pages 50-60.
[5] (1981) 150 CLR 1
[6] See Gibbs CJ at 11-12, Mason J at 16, 19-20 and 23, and Brennan J at 25-27
[7] See in particular Mason J at 23 and Brennan J at 27
[8] (1988) 18 ATR 827
[9] At 834

the subject of the charge are no longer in reality owing to the taxpayer but to the chargee.

The former view would seem to have found favour with Burt CJ in Norgard v DCT (WA) (1986) 18 ATR 270; 86 ATC 4947 in which case his Honour said, at (ATR) 275-6; (ATC) 4952:

It was, in fact, the latter view which is to be found in the judgment of Mason J in Clyne's case (1981) 12 ATR 173 at 182; 150 CLR 1 at 16 for his Honour there speaks of the effect of the crystallisation of a floating charge as having the effect that the moneys owed by the debtor would not be payable to the taxpayer."

3.2 Williams J went further and stated that,[10]

"*Though it is not necessary to decide the point I should indicate that I agree with the approach taken by the Full Court of Western Australia in Norgard v DCT (1986) 18 ATR 270; 86 ATC 4947 that the Commissioner is entitled to intercept moneys from persons who were debtors of the taxpayer and who received notices prior to crystallisation of the charge, but that the Commissioner would take debts subject to the security if it crystallised prior to the time of service of the notices.*"

3.3 Accordingly, the Full Court of the Supreme Court of Queensland has clearly indicated that, where a floating charge over book debts has crystallised into a fixed charge prior to service of a notice by the ATO on the debtor, the Commissioner takes the proceeds of those book debts subject to the fixed charge.

3.4 The decision of the Full Court of the Supreme Court of Western Australia in *Norgard v Deputy Commissioner of Taxation*,[11] to which the Court in *Tricontinental* referred, was another case of a secured creditor holding a floating charge over book debts, which the Commissioner garnished through service of a notice on the debtor. In relation to the interaction between crystallisation of a floating charge over book debts with notices served by the Commissioner on a taxpayer's debtors, Burt CJ held,[12]

"*So if at that time the bank's security was a floating security which had not crystallised there would be no security attaching to the debt. It would, as they say, be "hovering" over it. If, on the other hand, the bank's security over the book debts was at all times fixed or if it was when created floating but as at the time when the s 38 notice was served it had crystallised and so had become fixed, the Commissioner would take the debt subject to that security. That conclusion is I think implicit in the reasons of Mason J in Clyne's case, see (ATR) 182; (CLR) 16 and (ATR) 186-7; (CLR) 23, and can I think in reason be sustained either in the way which I have chosen or by saying that to the extent of the security the debt although due is not payable to the taxpayer. In this way the questions whether the bank's security was fixed or floating and if floating, whether and when it had crystallised become of critical importance.*" (Our emphasis)

3.5 Again, this decision supports the proposition that where a floating charge over book debts has crystallised into a fixed charge prior to service of a notice by the

[10] At 837
[11] (1986) 18 ATR 270
[12] At 276

Commissioner on the debtor, the Commissioner takes the proceeds of those book debts subject to the fixed charge.

3.6 The most salient case in the line of authorities on the question of competition between a notice and a floating charge over the taxpayer's asses is the decision of the Supreme Court of Queensland in *Elric Pty Ltd v Taylor*.[13] In that matter, a secured creditor had an equitable mortgage over the property of the taxpayer, which was in liquidation. The floating charge crystallised when a receiver was appointed by the secured creditor.

3.7 Subsequently, pursuant to a scheme of arrangement made in relation to the taxpayer, land owned by the taxpayer was sold by the trustees of the scheme for $4.4 million. The sale price was sufficient to repay the co-owners and thereafter the trustees intended to pay the balance to the secured creditor. In the interim, however, the Commissioner had issued an assessment against the taxpayer and then served the trustees with a notice under s 218 of the *Income Tax Assessment Act* requiring them to pay the assessed amount to the Commissioner for moneys due or accruing due by them to the taxpayer.

3.8 After referring to the decisions in *Clyne*, *Tricontinental* and *Norgard*, Thomas J held that,

> "*The question, therefore, is whether those moneys will be due and payable by the trustee to the taxpayer... In the present circumstances there is no prospect whatever that those moneys will be payable to* [the taxpayer]. *There is no question here of the moneys being sufficient to exceed Elric's secured debt so as to leave a surplus payable to the taxpayer. It is not really necessary to go further into the essential nature of the rights created by an equitable charge when it crystallises or the nature of the relationships inter se of creditor, debtor and chargee when this happens. It seems to me that both principal submissions on Elric's behalf are correct. I would hold that after crystallisation of a charge over all assets (present and future) of a taxpayer, moneys due to the taxpayer by third parties are no longer payable to the taxpayer. They are payable to the chargee, and only it may give a valid discharge. The same may be said with respect to future debts as they fall due. The same again may be said in relation to persons who hold or may hold money for or on account of the taxpayer.*"

3.9 This statement makes it very clear that the Court considers that a crystallised floating charge over book debts will defeat a notice served by the Commissioner attempting to garnish those debts. The decision has not subsequently been doubted.

3.10 Indeed, in *Zuks v Jackson McDonland*[14] the Supreme Court of Western Australia, after referring to the decision in *Elric*, stated that,[15]

> "*It will be apparent from the aforegoing review of the case law that there is now a substantial body of authority to support the proposition that, upon the proper construction of s 218, service of a notice under that section will not defeat a prior equitable charge. That appears to have been the view of*

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[13] (1988) 19 ATR 1551
[14] (1996) 33 ATR 40
[15] At 49

Brinsden J in Lai, in respect of the equivalent provisions of the Sales Tax legislation and it was certainly the view of Burt CJ on the appeal from his Honour's decision. It was also that of each of Williams J in Tricontinental Corporation and Thomas J in Elric. The proposition is also consistent with each of the judgments in Clyne and is, I think, at least left open by what was said by Kennedy J in Lai and by Connolly and Shepherdson JJ in Tricontinental Corporation.

It seems to me that in such a case, on the proper construction of s 218 and having regard for the authorities to which I have referred, the Commissioner's entitlement to receive payment of the debts referred to in the notices should be found to be subject to the interest of the prior equitable assignee."

3.11 That decision is consistent with the conclusion reached by Thomas J in *Elric*.

3.12 Most recently, in the Supreme Court of Queensland decision in *Re Octaviar Ltd (No 8)* the views in *Elric* have been followed. The taxpayer had guaranteed a facility extended by a financier to the group, Fortress. As security for performance of the guarantee, the taxpayer granted a fixed and floating charge (charge) to Fortress. The charge was, as regards book debts owed by third parties to the taxpayer, a floating charge.

3.13 The floating charge was agreed to automatically crystallise upon certain events occurring, including "insolvency events" that occurred in relation to the taxpayer. Since at least the time of the Court of Appeal's decision in *Fire Nymph Products Ltd v The Heating Centre Pty Ltd (in liq)*[i] automatic crystallisation clauses in floating charges have been held to be effective in causing floating charges to crystallise into fixed charges in accordance with the terms of the clause in question.

3.14 In *Octaviar*, McMurdo J considered each of the decisions discussed above. After considering the two different approaches to the question of priority discussed in *Norgard* and after having regard to the decision in *Elric*, McMurdo J held as follows (at [48]–[50]):

> *"... under the first approach, the Commissioner would be entitled to payment of the debt but would hold the proceeds subject to the fixed charge, whereas the second approach would deprive the Commissioner of the right to receive payment at all. If the first approach were applied here, OA would have to pay to the Commissioner an amount up to the amount of the notice, but (again assuming the validity of the Fortress charge) the Commissioner would then have to pay to Fortress the amount which its charge secured because the beneficial ownership of the funds would be in Fortress. Under the second approach, the notice would not require OA to pay to the Commissioner whilst Fortress was entitled to the funds for payment of what was secured by its charge. Either way, the result, at least absent the impact of the DOCA for OL, would be a payment or payments to Fortress or its receivers.*
>
> *Any surplus funds, that is, funds not to go in payment of the Fortress debt, would not have to be paid by OA to Fortress or to the receivers, on either of the two approaches...*

In summary, the notice does not defeat the operation of the Fortress charge (if otherwise valid) and is ultimately effective only to the extent that monies to be paid by OA would not have to be paid to Fortress in payment or part payment of its debt."

3.15 Accordingly, Fortress was (subject to the validity of its charge, a matter that remains in contention) successful in the priority contest with the Commissioner.

4. External administration of the taxpayer

4.1 Turning to the service of notices on companies in external administration, two cases need to be considered.

4.2 In *Bruton Holdings*, the question was whether or not the Commissioner was able to effectively issue a notice after the winding up of the taxpayer of the notice had already begun.

4.3 In 2004, the taxpayer applied for endorsement as an income tax exempt charity. The Commissioner refused that application and Bruton Holdings appealed to the Federal Court. The trial was due to come on in 2007. In the meantime, the sole director resolved to place the taxpayer in administration. On the same day, $450,000 was placed in the trust account of the lawyers prosecuting the appeal against the failed endorsement application. In March 2007, the Commissioner issued the taxpayer with a notice of assessment for the 2004 financial year in the amount of $7,715,873.73.

4.4 On 30 April 2007, Bruton was placed in a creditors' voluntary winding up. Subsequently, the Commissioner served notices on Bruton Holdings' lawyers to recover funds held in trust in payment of the company's tax liability.

4.5 By unanimous decision the High Court reversed a controversial decision of the Full Federal Court to confirm that the Commissioner cannot 'leap-frog' other creditors in a liquidation by issuing a notice after the company has been placed into liquidation.

4.6 It is important to appreciate, however, the difference between the date on which the winding up commences and the "relation-back day".

4.7 The "relation-back day" is relevant to such matters as to how far back in time a liquidator's avoidance powers (unfair preferences, uncommercial transactions, etc.) will be effective.

4.8 The "relation-back day" is not relevant to when section 468 of the *Corporations Act* (or its counterpart provision for purposes of voluntary liquidations, section 500), which voids dispositions and attachments made by or against a company in liquidation, takes effect – section 468 operates with effect from the date on which the winding up commences. Accordingly, the date on which the winding up commences is the relevant date for purposes of testing the efficacy of the Notice as against a liquidator of OL.

4.9 The situation in *Bruton Holdings* is therefore not analogous to another, perhaps more important set of circumstances – the ability of the Commissioner to serve a notice before the date of commencement of any winding up, but after the "relation-back day".[16] This is particularly relevant to instances where a lengthy

[16] A similar decision was made in *Bruton Holdings Pty Ltd (in liq) v Commissioner of Taxation* (2007) 244 ALR 177 in the context of a voluntary winding up.

voluntary administration under Part 5.3A of the *Corporations Act* precedes a liquidation.

4.10 In *Brown v Brown*[17] a notice had been served on a taxpayer's debtor before the commencement of the taxpayer's winding up but after the "relation-back day" for the taxpayer. It was held that the notice was valid – the effect of section 468 of the *Corporations Act* (voiding dispositions of the taxpayer's property after commencement of its winding up) was not applicable because it did not apply from the "relation-back day" but from the date of commencement of the winding up.

4.11 The decision in *Brown v Brown* has not been disapproved in the subsequent decision in *Bruton Holdings* and, it seems, remains the law in Australia.

4.12 In *Macquarie Health Corp Ltd v Commissioner of Taxation*,[18] a notice served by the Commissioner was, consistently with the later decision of the High Court in *Bruton Holdings*, held to be ineffective in circumstances where it had been served after the commencement of the debtor's liquidation.

4.13 It was, however, decided in *Macquarie Health Corp* that a notice could not be set aside as an unfair preference in the taxpayer's winding up – this was because the notice did not involve the taxpayer entering into a "transaction" for the purposes of section 588FA of the *Corporations Act*.

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[17] [2007] FCA 2073
[18] (1999) 96 FCR 238