

FEATURE ARTICLE



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The forgotten tax priority

The liability of receivers for unremitted capital gains and income tax



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The corporate law reforms of the early 1980s and those that followed the Harmer Report in the early 1990s, resulted in the general removal of any priority for the payment of taxation liabilities in the winding up of companies.¹ These reforms are generally understood as providing that the Crown must stand in line with other creditors to receive payment out of an insolvent estate, at least in respect of pre-liquidation liabilities.

However, in a receivership, the operation of s 254 of the *Income Tax Assessment Act 1936* (Cth) (1936 Act) is often overlooked and has the ability to undermine this general understanding of the order in which payments are made. Section 254 can create a priority for the Commissioner of Taxation and also imposes a personal liability on the receiver to pay tax on pre-appointment capital gains when they are realised by a receiver.

This article examines the effect of s 254 and how it operates to create a priority over creditors, including secured creditors. Arguments to the contrary ignore the plain language of the section. It can, however, be argued that s 254 ought to be read in accordance with the general expectation of creditors so as not to allow the Commissioner to jump the queue. It appears that insolvency professionals and others encountering s 254 often presume that this alternate interpretation is correct, particularly in light of the general understanding of the removal of the Commissioner's priority.

This article also examines the criteria necessary for the liability to arise and the manner in which the section operates depending on the method of enforcement.

An important lesson for all secured creditors and insolvency practitioners, in the absence of any legislative change, is that the potential for personal liability under s 254 should always be considered when enforcement action is contemplated.

A receiver's liability for tax

The tax liabilities of receivers are determined by reference to s 260-75 of Schedule 1 of the *Taxation Administration Act 1954* (Cth) (TAA Act) and ss 254 and 255 of the 1936 Act.

Section 260-75 requires a receiver to give notice to the Commissioner of having taken possession of a company's assets. Section 260-75(3) requires the Commissioner 'as soon as practicable', to notify the receiver of the amount that the Commissioner considers is sufficient to discharge the 'outstanding tax related liabilities' of the company at the time the notice is given. It is a section that deals with the pre-receivership tax liabilities of the company in receivership.

The receiver must not, without the permission of the Commissioner, part with any of the company's assets before receiving the Commissioner's notice. However, importantly for secured creditors, s 260-75(5) does permit the receiver to pay secured debts and debts required by an Australian law to be paid in priority to other debts of the company without receiving clearance from the Commissioner.

Once notice is received from the Commissioner, the receiver is required to set aside and retain out of the funds available to meet unsecured, non-preferential creditors (for example those prescribed by ss 433 and 556 of the *Corporations Act 2001* (Cth) (Corporations Act) a proportion of the available funds calculated by using a prescribed formula (s 260-75(6)).

If the receiver does not set aside and retain the required amount for payment to the Commissioner, the receiver is personally liable to pay that amount (s 260-75(8)). Failure to comply with the above obligations is also considered an offence for which the receiver is liable to be penalised (s 260-80).

Whilst there is provision for the payment of secured creditors ahead of the Commissioner, subdivision 260-C is not an exhaustive code for the liability of receivers. Section 260-90 states that the subdivision 'does not reduce any obligation or liability of the receiver or receivers arising elsewhere'.

That liability appears to arise under ss 254 and 255 of the 1936 Act. In this context:

- ▶ Section 254 of the 1936 Act imposes obligations on all trustees and agents to do all the things required to be done under the Tax Acts in respect of income, profits or gains of a capital nature derived in a representative capacity, and in respect of the payment of tax thereon (s 254(1)(a)). Relevantly, s 6 of the 1936 Act defines Trustee to include, for example, a receiver, executor or administrator, guardian, committee or liquidator.
- ▶ Section 254(1)(d) states that the receiver 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'.
- ▶ Section 254(1)(e) states that the receiver is 'made personally liable for the tax payable' in respect of the gain to the extent of any amount that he 'has retained or should have retained under paragraph (d)'.

The operation of s 254 to create a personal liability of a receiver on income, profits or gains of a capital nature derived during the receivership is plainly clear.

Section 255 of the 1936 Act is worded in similar terms to s 254 and addresses a situation where a receiver is in receipt or control of money of a non-resident. The receiver will be made personally liable for the tax payable 'in respect of any gain to the extent of any amount that he has retained or should have retained'.

While s 260-75 allows a receiver to pay secured debts and certain other prescribed debts in priority to pre-existing tax debts, ss 254 and 255 of the 1936 Act do not incorporate any such provision and impose, on their face, not only an obligation to retain tax in respect of any income, profits or gains of a capital nature made by the receiver, but also, a personal liability if the requisite amount is not retained.

The priority

In the receivership of a trading company the existence of a provision such as s 254 is not surprising. The statutory provisions of the Corporations Act² which provide for personal liabilities for receivers are not broad enough to catch a liability for income tax.³ Accordingly, without a provision such as s 254 a receiver may well be able to continue to trade a business and to repatriate the income generated to his or her appointer whilst leaving the liability for the tax due on that income as an unpaid debt of the company. Section 254 is effective to ensure that for so long as a receiver derives income from trading the business to which he or she is appointed, the tax due on that income is paid.

From a policy perspective, this operation of s 254 does no damage to the ordinary order in which creditors are paid as the tax liability derives only from new income generated post the receiver's appointment.

However, the plain language of s 254 and the position that appears to have been adopted by the Commissioner from time to time, sees the section reach beyond trading income derived during the course of a receivership to capture capital gains which are realised during that receivership.

Where a receiver realises an asset which results in a capital gain, s 254(1)(a) requires the receiver to account to

the Commissioner out of the proceeds of sale any capital gains tax liability which crystallises as a result of such realisation. Section 254 will also be enlivened where a receiver derives income from the sale of valuable 'stock in trade', which can include development units where the company in receivership has developed the units and is taxed as a trading entity rather than on a capital gains tax basis. If there are no or insufficient pre-appointment tax losses against which to offset the income or gain, tax will be payable on the income and, by virtue of s 254(1)(e), the receiver will be personally liable for the payment of that tax.

In such a situation, it would appear that a receiver would distribute the funds held in the following order:

- 1 first, in satisfaction of the tax liability and any other personal liabilities incurred during the receivership;
- 2 second, in satisfaction of his or her remuneration;
- 3 third, to the secured creditor in satisfaction of the secured debt; and
- 4 finally, any surplus will be distributed amongst unsecured creditors or returned to the company.

The significance of the apparent priority created by s 254 can be seen by comparing the order of payments above with that which would be made if a property were sold by a secured creditor exercising its power of sale. Whilst not entirely settled, in such circumstances, the secured creditor would satisfy the secured debt (including the realisation costs) from the sale proceeds and the surplus would be distributed amongst unsecured creditors or returned to the company. Any liability for tax in relation to the sale of the property would be a matter for the company or its liquidator. We address the impact of a sale by a mortgagee in possession in greater detail on the following page.

¹ The *Taxation Debts (Abolition of Crown Priority) Act 1980* (Cth), *The Crown Debts Priority Act (1981)* (Cth), *Insolvency (Taxation Priorities) Amendment Act 1993* (Cth).

² Sections 419 and 419A of the Corporations Act. ³ O'Donovan, 'Company Receivers and Administrators', Law Book Co, 11-5069.

Contrary interpretations and approaches

There are a number of possible alternate constructions of section 254 such that it does not operate as a priority.

Legislative intention – construing as contrary to purpose of removal of tax priorities

The first potential argument raised against the operation of s 254 to grant a priority to the Commissioner is that the section must be read down given that it is contrary to the corporate law reforms which removed the historical priorities granted to the Commissioner. Those reforms had the purpose and intention of removing all priority that the Commissioner may have had for tax debts. When examining the history of s 254 and the history of Crown priorities (and their removal), it is apparent that this argument cannot be maintained.⁴

There is, however, a clear legislative intention that the Commissioner should not have a priority for debts on gains of a capital nature. It is clear from ss 433 and 556 of the Corporations Act (which specifically deal with priority creditors) that the Commissioner does not have priority over any other category of creditor. The Commissioner is to rank *pari passu* with all other unsecured creditors. If the intention were for the Commissioner to have priority, one would assume that the legislature would have specifically addressed that priority at least in s 556 of the Corporations Act.

Further, if s 254 gave the Commissioner priority over a secured creditor:

- ▶ it would be inconsistent with a later Commonwealth statute (the Corporations Act) and, therefore, would be impliedly repealed by the more recent enactment to the extent of any inconsistency;⁵ and
- ▶ it would be inconsistent with subdivision 260-C of Schedule 1 to the TAA Act (also a later Commonwealth statute) which would impliedly repeal s 254 to the extent of the inconsistency. As detailed above, subdivision 260-C deals with pre-appointment liabilities and confirms that such liabilities do not obtain a priority over a secured creditor.

Section 254 only enlivened upon an assessment being issued

If there are monies which 'come to' the agent, s 254(1)(d) provides that such an 'agent' is authorised and required to retain, from that money, 'so much as is sufficient to pay tax which is or will become due in respect of the income, profits or gains' (our emphasis). Section 255(1)(b) is in relevantly identical terms to s 254(1)(d), the only difference being the substitution of the words 'comes to him on behalf of a non-resident' for 'comes to him in his representative capacity'. Relevantly, s 255(1)(b) qualifies the obligation to retain monies in exactly the same terms as does s 254(1)(d), namely that the controller retain 'sufficient funds to pay tax which is or will become due in respect of the income, profits or gains'.

Taxation Ruling IT2544 provided guidance as to the application of ss 254 and 255 of ITAA 1936. The Commissioner's view was that the obligation to retain a sufficient amount to satisfy tax liabilities was not contingent upon an assessment having been issued. Rather, ss 254 and 255 operate of their own force and the obligation arises upon a notice being provided which informs an agent, trustee or representative of a potential tax liability.

The operation of s 255(1)(b) was considered by the High Court of Australia in *Bluebottle UK Ltd v DCT*.⁶ The Court held that s 255(1)(b) can only operate once an assessment has been issued. In light of this decision, the Commissioner withdrew Taxation Ruling IT2544 on 23 June 2010.

Whilst *Bluebottle* did not address s 254 of the 1936 Act, there is no reason in principle to suggest that s 254(1) should operate any differently to s 255(1). To the contrary, the Court's reasoning with respect to s 255(1)(b) applies directly to s 254(1)(d). The High Court's finding as to the operation of s 255(1)(b) was applied to s 254(1)(d) in *Barkworth Olives Management Ltd v DCT*.⁷ In this context, it is arguable that the obligation to retain 'sufficient funds' can only arise once an assessment has been issued. It may be possible for a receiver to contend that no liability should attach under s 254 for failing to remit tax on capital gains if funds are remitted in the ordinary course and to the secured creditor before the Commissioner issues an assessment.

⁴ See for example, the analysis of the removal of the priorities in *Deputy Commissioner of Taxation v Dexcam Australia Pty Ltd (in liquidation)* 46 ACSR 406.

⁵ *Goodwin v Phillips* (1908) 7 CLR 1 at 7. ⁶ *Bluebottle UK Ltd v DCT* (2007) 232 CLR 598 (*Bluebottle*). ⁷ *Barkworth Olives Management Ltd v DCT* (2010) ATC 20-172 at 10,828 [29].

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While these alternate constructions are attractive, they are not a substitute for legislative reform or judicial clarification of s 254. It is submitted that the risk of personal liability attaching to a receiver for failing to retain a sufficient amount on account of any tax on capital gains that may become payable in reliance on any one of the above arguments is more than any prudent receiver should accept. Absent legislative reform or judicial clarification of the nature and extent of the priority, a receiver should take proactive steps to avoid the risk of liability.

The uncertainty surrounding the s 254 priority and the cautious approach that ought be taken by receivers to overcome that uncertainty has the potential to delay the finalisation of a receivership and the retirement of receivers.⁸ In the interests of the efficient administration of a receivership and the return of control of a company in receivership to its directors or its liquidator (as the case may be) at the earliest opportunity, clarification of the operation of s 254 is a matter of utmost importance.

Application of Section 254 to mortgagees in possession

Section 254 only applies to agents and trustees. As detailed above, the operation of s 254 is extended by the statutory definition of 'trustee' in s 6 of the 1936 Act, which provides that:

trustee in addition to every person appointed or constituted trustee by act of parties, by order, or declaration of a court, or by operation of law, includes:

- (a) an executor or administrator, guardian, committee, receiver, or liquidator; and
- (b) every person having or taking upon himself the administration or control of income affected by any express or implied trust, or acting in any fiduciary capacity, or having the possession, control or management of the income of a person under any legal or other disability;

The courts have held that a mortgagee in possession does not act in a trustee capacity and that mortgagees who take possession do not thereby assume a fiduciary relationship with the mortgagor.⁹ Assuming the debtor is not under any legal or other disability, the only potential to include a mortgagee in possession as a 'trustee' for the purposes of s 254 would be if the mortgagee in possession fell within the specific capacities set out in sub-section (a) of the definition of 'trustee'. That is, if they were acting as 'an executor or administrator, guardian, committee, receiver, or liquidator'.

Accordingly, in the normal course, s 254 should not apply to mortgagees in possession.

Mitigating the risk of personal liability

A prudent receiver may wish to take steps to determine the possible capital gain that the Commissioner will ultimately seek to tax and the available losses that may be able to offset such liability.

If there is a gain, which, on its face, may well give rise to a liability under s 254, then a receiver should consider obtaining a tax ruling as to that liability. While a tax ruling is not binding on a ruling applicant, if the ruling is favourable and the applicant abides the ruling, the Commissioner cannot then complain about the applicant's actions in compliance with, and reliance on, that ruling. There are, of course, various avenues of administrative and judicial appeal for a ruling which is unfavourable or otherwise not satisfactory to a receiver.

Conclusion

The operation of s 254 of the 1936 Act requires clarification. The fact that a receiver will be held personally liable for gains of a capital nature to the extent that sufficient sums to satisfy that liability are not withheld is, in many respects, a hidden or forgotten tax priority. It is submitted that s 254 and the Commissioner's interpretation of that section does not accord with the intention of the abolition of the priority for income tax in an insolvency context. If, for policy reasons, it is intended that the Commissioner stand in line with other unsecured creditors in an insolvency context, then the priority apparently arising by virtue of the operation of s 254 must be addressed. The policy argument for clarifying this purported priority is plainly apparent when considered in the context of the impact that such priority will likely have on insolvency practitioners and possibly secured creditors.

Until such time as legislative reform or judicial clarification of s 254 occurs, a receiver must consider the risk of personal liability attaching for failing to remit tax on gains of a capital nature and should tread carefully and take all necessary precautions. ▀

Ed note: The question of the personal liability of an external administrator for capital gains tax on the sale of an asset after appointment is one on which the IPA and the insolvency profession is awaiting a view from the ATO. The IPA raised this with the ATO on behalf of its members some time ago. The IPA may suggest law reform if the law is not clear or is unfair to other creditors. The views expressed in this article will assist consideration of the legal issues involved.

⁸ Refer generally to *Bowesco Pty Ltd v Cronin* [2008] WASC 296. ⁹ *Chant v DCT* 94 ATC 4733 and *DCT v General Credits Ltd & Ors* 87 ATC 4918 are the leading authorities on this issue.



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