THE TAX INSTITUTE

NSW 5TH ANNUAL TAX FORUM

Taxation and Insolvency

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NSW Division
17-18 May 2012
Hilton, Sydney

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1 OVERVIEW

Tax considerations will inevitable arise whenever there is an insolvency situation arising in respect of a company.

One important area are the relevant considerations in respect of external administrations particularly relating to past and future tax liabilities of the company and the duties and responsibilities of those that control the company. The first and second parts of this paper addresses the relevant considerations here.

The third part of the paper addresses the common tax issues and considerations that arise when a members' voluntary liquidation is pursued to access the value from a company.

2 EXTERNAL ADMINISTRATIONS

2.1 Common Types of External Administrations

Whilst there are many and varied types of external administrations used to address an insolvency situation, many advisors have a limited appreciation for the differences between them, the various rights and obligations of stakeholders as well as the powers and duties of an external administrator under those different processes.

In Corporate Insolvencies, the most common external administrations include:

- Creditors Voluntary Liquidation (CVL) – A process whereby control of a company and its affairs are placed in the hands of a Liquidator by a company's Directors and Shareholders. A Liquidator undertakes the task of dissolving the company, which includes reporting to creditors and determining the ability of a company to provide a return to parties having claims against it.
- Court/Official Liquidation – A process similar to a CVL but initiated by the Courts, often on the application of a creditor on the grounds of insolvency.
- Voluntary Administration – A process usually initiated by Directors whereby an independent external party (a Registered Liquidator) assumes control of the company and its assets, reviews its affairs and makes a recommendation to creditors for the creditors to decide the company's future. This can include:
    - I. Accepting a proposal in relation to the company's future in the form of a Deed of Company Arrangement; or
    - II. The company being placed into a Creditors Voluntary Liquidation and wound up; or
    - III. The company being returned to the Directors and the Administration being brought to an end.
- Receivership – A process initiated by a creditor holding security against a company's assets whereby the secured creditor's representative takes control of and sells the security to pay down the debt due to them.

The most common insolvency processes for Personal Insolvencies include:

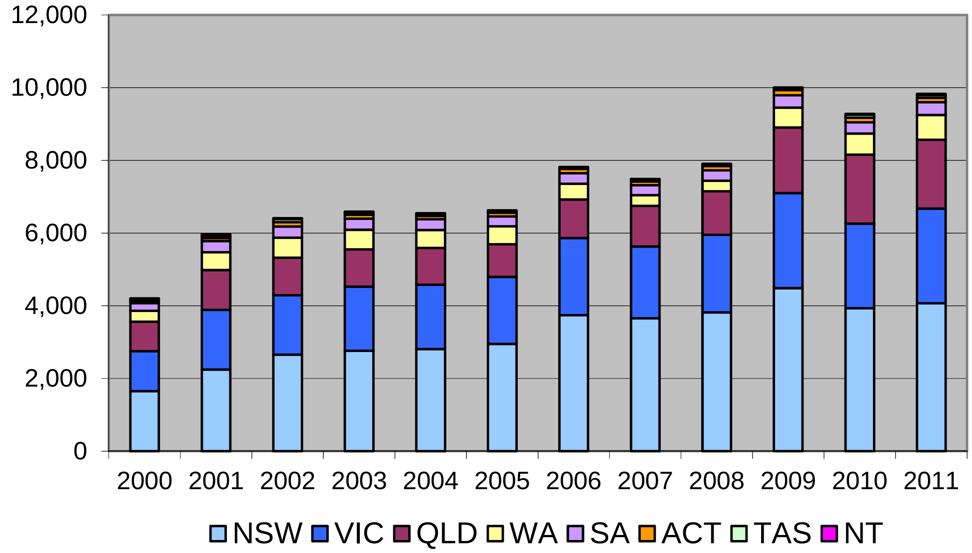
- Bankruptcy – Generally a 3 year process initiated by either the debtor (the Bankrupt) or a creditor whereby a Registered Trustee is appointed to a Bankrupt estate. Reports to creditors and deters the ability of the estate to provide a return to parties having claim against it.
- Controlling Trusteeship - A process initiated by a debtor whereby they put a proposal to their creditors via an independent external party who assumes control of the debtor's assets, reviews their affairs and makes a recommendation to creditors in relation to the proposal. If accepted by creditors, the proposal takes the form of a Personal Insolvency Agreement (PIA).
- Debt Agreement – Is a simplified PIA restricted to debtors whose affairs fit within certain prescribed thresholds around the level of their debts, assets and income.

2.2 Insolvency Rates

Insolvency rates have climbed over the last decade on both the Corporate and Personal Insolvency fronts.

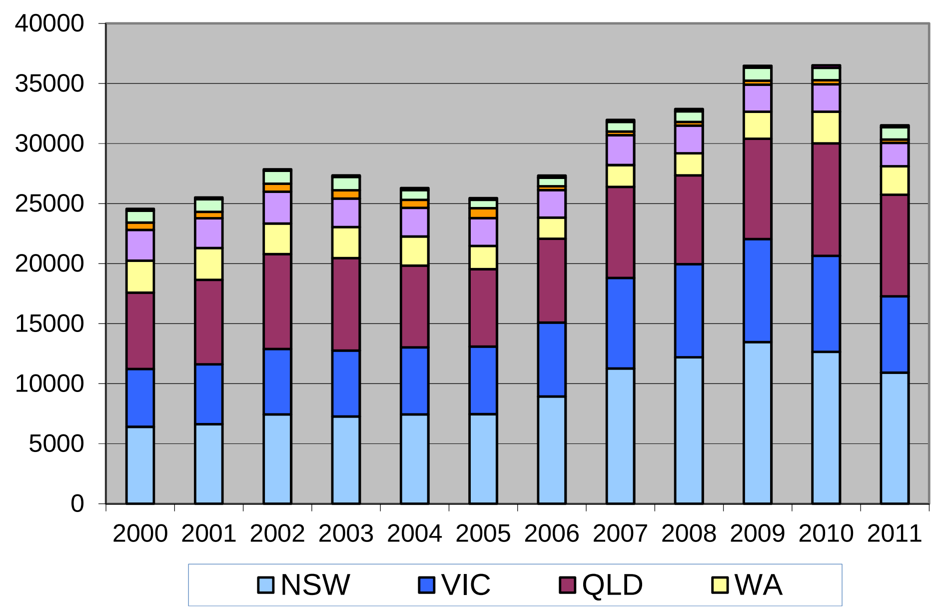
The incidence of Corporate Insolvencies more than doubled from the 2000 financial year to the 2010 financial year. In the aftermath of the 2008 Global Financial Crisis these external administrations now hover around 10,000 annually.

Corporate Insolvencies



There has also been a growing trend in the incidence of Personal Insolvencies since the 2005 financial year climbing to over 36,000 appointments between 2009 and 2011. This number has since reduced with over 31,000 appointments in the year ending 30 June 2011. The proposed changes to the Director Penalty Notice regime, which I will discuss shortly, are likely to placed upward pressure on Personal Insolvency rates with the scope of personal liability to be increased.

Personal Insolvencies



3 DIRECTORS DUTIES AND OBLIGATIONS

3.1 Directors

Given the current economic conditions and the increased level of insolvencies in Australia, Directors need to remain vigilant when it comes to discharging their responsibilities as Directors to avoid exposure to personal financial risk.

Definitions of a Director can be found under section 9 of the Corporations Act 2001 (CA) and also section 8A of the Taxation Administration Act 1953 (TAA). The definitions are generally consistent with each other and give rise to 3 different types of Directors which I have highlighted below. These include:

1. Validly appointed Directors
2. Shadow Directors (Deemed Director)
3. Defacto Directors (Deemed Director)

<u>Validly appointed Directors</u>
This relates to Directors appointed by the shareholders of a company in the usual manner. These Directors have their positions recorded with the Australian Securities and Investments Commission and carry the title of Director.

<u>Shadow Directors</u>
These are people not appointed as Directors, but may be Deemed Directors by acting behind an appointed Director in a manner that is otherwise consistent with a Directorship.

<u>Defacto Directors</u>
This is another form of Deemed Director whereby a person, not being an appointed Director, otherwise acts as though they are an appointed Director and the company is accustomed to acting in accordance with their instructions.

3.2 How do I avoid being deemed a Director

As I will discuss below, there are a number of obligations and pitfalls for Directors.

Advisors need to be careful when helping clients to ensure they don't overstep the mark and end up being deemed a Director, thereby assuming much the same risk and exposure.

The TAA does make a distinction between an advisor and a Director. It reads

> *"For the purposes of the definition... a person shall not be regarded as a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act by reason only that the directors act on advice given by that person in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors"*

To aid in this endeavour there are a few simple things that advisors can do, or not do, to draw a line between themselves and Directors. These include:

- Utilising engagement letters wherever possible. This ought to identify the limits of your responsibility and identify your involvement as being in the capacity of an advisor.
- Noting the difference between advice and instructions. Remember that the decisions rest with the client and your role is to provide information to assist them in their decision making process. The tip here is to put advice in writing wherever possible.
- Avoid signing cheques. Being a signatory on your client's accounts is a prime indicator that you may hold the authority of a Director and have the power to commit the company's resources.
- Do not sign company documents or authorisations. This is something that should be left to Directors.

- Try to avoid negotiating directly with creditors. Holding yourself out to have the power to make decisions on behalf of the company can also place you in a difficult position.

3.3 Obligations of Directors

Directors have broad ranging obligations arising out of statute and case law when it comes to managing the affairs of a company. It is important to note that the obligations of Directors under the CA and the TAA also extend to Deemed Directors.

These obligations range from maintaining proper books and records, preventing a company from trading whilst insolvent, exercising due care and diligence, acting in good faith and acting for a proper purpose, to ensuring that a company pays its taxes.

Other specific duties and obligations exist for Directors in the context of an external administration, such as assisting the External Administrator, completing reports and providing information.

3.4 Director Penalty Notices

<u>What is the relevance?</u>

A Director Penalty Notice (DPN) is a notice issued by the Commissioner of Taxation (Commissioner) under the schedule 1, 269-25 of the TAA (formerly 222AOE of the Income Tax Assessment Act 1936 (ITAA)) to the Director of a company that has failed to remit an amount of money withheld, being amounts of Pay As You Go (PAYG) withholding.

The objective of the legislation as set out under schedule 1, 269-5 of the TAA is to ensure that a company meets its obligations to pay withholding amounts to the Commissioner or is otherwise promptly placed into external administration.

Notwithstanding the original intention of the DPN regime, there has been a strong push in recent years to extend the scope of these laws to help curb Phoenix activity. Phoenix activity being the situation where a business closes overnight and starts up the next day with the same name, the same assets, and possibly the same Directors, whilst leaving behind a trail of debts (often tax debts) with little or no hope of creditors receiving their money.

In a proposal released by the Federal Treasury in November 2009, the problem of Phoenix activity was estimated to have cost Australians $600 million in lost revenue. This proposal suggested a number of changes to laws and followed a pre election commitment from the Labor Party in 2007 to address the problem.

<u>Background</u>

The DPN regime was introduced in 1993 with the commencement of Voluntary Administration laws when the Commissioner lost the right to ultimate priority as a creditor over the assets of a defunct company. The Commissioner was relegated to the position of an ordinary unsecured creditor, joining the ranks of contractors, trade creditors and suppliers. The Commissioner did however pick up a few special privileges at that time, including the DPN regime which remained largely unchanged until 1 July 2010.

The mechanics of the original process to 30 June 2010 were that the Commissioner would issue the DPN by post to the Directors. The DPN then allowed the Commissioner to recover the outstanding amount from the Director in the form of a penalty, unless the penalty was remitted by one of the following acts within 14 days:

- The company paid the debt; or
- The company entered into a repayment arrangement under section 222ALA of the ITAA; or
- The company was placed into Liquidation; or
- The company was placed into Voluntary Administration.

Whilst there has historically been some debate around whether the 14 day penalty remission period commenced from the time the Commissioner posted the notice or from the time the notice was received by the Director, the current laws which came into effect on 1 July 2010 confirm that the timeframe starts from the date of postage. This means if the notice is delayed or not received by a Director, then it is a problem for the Director, not the Commissioner.

The proposals in the November 2009 Treasury paper talked about a number of changes to curb Phoenix activity which amongst others, included:

- Removing the ability of Directors to avoid personal liability by appointing a Voluntary Administrator or Liquidator;
- Increasing the scope of DPN's to include unpaid superannuation;
- Considering whether the scope of DPN's should be further widened to include other direct and indirect taxes, including GST;
- Denying PAYG credits to Directors where the company has not remitted amounts withheld;
- Restricting the use of similar names in new entities to discourage Phoenix companies; and
- Authorising the Commissioner to require a company to pay a security bond

3.5 The Current DPN Regime

A small number of changes were made effective 1 July 2010. This included:

- The notice period during which the penalty can be remitted was extended from 14 days to 21 days; and
- The ability to enter into a repayment arrangement was removed, meaning the only way to avoid the personal penalty now is to:
  i. Pay the debt; or
  ii. Appoint a Liquidator; or
  iii. Appoint a Voluntary Administrator.

3.6 The ongoing DPN debate

There are still a number of proposed changes to the regime and the discussion around them has intensified.

In October 2011, changes were put before Parliament only to be withdrawn following concerns that the new laws, if implemented, would have implications far beyond dealing with Phoenix activity.

The October 2011 proposals included:

- Extending the DPN regime to cover Superannuation, as well as PAYG; and
- Removing the need to issue a DPN before pursuing a director personally, making directors automatically liable for amounts that had not been remitted 3 months after their due date.

These proposals have been further refined and the latest amendments were briefly issued as an exposure draft for public consultation in April 2012. The current proposals are still likely to be subject to vigorous debate. Whilst the new legislation addresses the same policy intent, it contains several important changes which could become law as early as the winter sitting of Parliament.

If this is the case, the updated regime will look a little something like this:

- The new provisions reintroduce the expansion of the regime to superannuation guarantee amounts. That is, company Directors will effectively be made personally liable for their employees' unremitted superannuation contributions.
- In circumstances where a DPN is issued, the penalty will be calculated as at the lodgement date for the superannuation guarantee statement (generally one month after the quarterly payment due dates for superannuation to the employees' funds).
- If a company fails to lodge a superannuation guarantee statement, the Commissioner can estimate the superannuation guarantee shortfall to quantify the amount of the Director penalty.

- A major departure from the previous proposal is the apparent abandonment of the automated recovery provisions for unremitted amounts after 3 months. Under the current proposal, the Commissioner will not be able to recover a Director penalty without first serving the DPN.

  There is however a sting in the tail. Under the law as it currently stands, a Director has the option of extinguishing the Director penalty if, within the 21 day notice period, the tax is paid, or the Director appoints a Voluntary Administrator or Liquidator to the company. Under the new proposal, in cases where the underlying tax is more than 3 months overdue, the Director penalty will not be remitted by placing the company into Voluntary Administration or Liquidation. So notwithstanding that Directors will continue to receive DPN's where the tax is 3 months overdue, personal liability will be almost impossible to avoid once the DPN is issued.
- Another proposal outlined in the exposure draft is the restriction of access for Directors and certain associates to PAYG (Withholding) credits where the company has failed to remit withheld amounts to the Commissioner. This policy proposal was also included in the earlier version of the legislative amendments, but under the new proposal the mechanics of recovery have been altered to prevent constitutional challenge. Rather than disallowing a credit to the taxpayer for his/her PAYG (Withholding) entitlement, the proposed recovery mechanism is now via the imposition of a PAYG withholding non-compliance tax on a relevant Director or associate. An 'associate' is very broadly defined in taxation legislation to include a spouse, partner, child or relative. Note that the Commissioner cannot recover the PAYG withholding non-compliance tax unless a notice is first issued to the individual Director or associate and a notice cannot be issued on a Director who has a Director penalty liability.
- There has been some 'softening' of the approach in the current proposal. The draft legislation includes a defence for DPN's in respect of superannuation guarantee debts in circumstances where a Director reasonably thought the worker was a contractor and not an employee and the Director acted in a manner consistent with this belief.
- The proposed laws contain some leeway for new Directors to familiarise themselves with a company's affairs before incurring a personal liability. For new Directors, Director Penalties will not apply until 30 days after their appointment as Director. And the proposed restricted remission options will not apply to new Directors until 3 months after their appointment, rather than 3 months after the due date.

3.7 Deregistration

Voluntary deregistration or ASIC initiated deregistration pursuant to sections 601AA and 601AB of the CA respectively does not prevent the Commissioner from issuing a DPN. In the event of a DPN being issued in relation to a deregistered company, to avoid the personal liability the company would have to be reinstated expeditiously, usually by the court and at a significant legal expense, to allow it to be placed into Liquidation or Voluntary Administration prior to the expiry of the 21 day notice period.

If the current changes proposed for the DPN regime are accepted, reinstatement may be futile as the liability would commence from the time the notice is issued without affording the Director the grace period to remit the penalty via a Liquidation or Voluntary Administration.

The tip here is to consider companies that may have a future exposure to PAYG or Superannuation audits and utilise a Members Voluntary (Solvent) Liquidations to negate the risk of personal liability from a DPN after deregistration.

3.8 Personal liability for tax paid?

As mentioned early, when the Commissioner lost the right to ultimate priority in the Liquidation of a tax payer, they received some special rights which included the DPN regime. In addition to this, the Commissioner also received the benefit of amendments under Part 5.7B of the CA which provided the Commissioner with a statutory indemnity against Directors for any payments clawed back from them by a Liquidator.

In essence, Directors are potentially providing a personal guarantee to the Commissioner each time the company makes a payment of any tax, penalty or interest, that the business won't fail and that its Liquidator won't claw back the payment as an unfair preference.

An unfair preference is a transaction which the company is a party to and at the time of the transaction the company was insolvent or otherwise became insolvent as a consequence of the transaction.

If it can be shown that as a result of that transaction the recipient received an advantage or priority ahead of other creditors and that the recipient knew or should have been aware that the company was insolvent at the time of the transaction, then the transaction may be void by a Liquidator.

There are some statutory defences to a preference claim which involve considering the net benefit of multiple transactions within the relevant period (Running Balance) or other defences such as good faith. The relevant period is 6 months prior to the commencement of the Liquidation or up to 4 years for related parties.

Therefore, if on the application of a Liquidator the Commissioner is found to have been the recipient of an unfair preference by the Court, then the Commissioner is obliged to repay that amount to the Liquidator and in return the Commissioner has the right of indemnity against the Director under section 588FGA of the CA for any loss or damaged suffered as a consequence of the order. In circumstances where a Liquidator is able to negotiate a settlement with the Commissioner, and the Courts determination is not required, then a Director won't be caught by the statutory indemnity and the Commissioner won't have recourse against the Director.

If a company is ultimately unable to make it through its challenges and a Liquidator is appointed, a Director in these circumstances could end up personally liable for the amount that the company has paid to the Commissioner in the period leading up to Liquidation. This potential exposure is a particular issue for Directors (and possibly Deemed Directors) in the aftermath of the Global Financial Crisis during which Directors have reportedly entered into 150,000 repayments arrangements with the Commissioner for debts in the order of $1.5 billion.

Businesses contemplating repayment arrangements ought to first consider a few fundamental questions, such as:

- Have we sat down with our accountant or business advisor to review our financial performance and prepared realistic forecasts?
- Have we considered what effect the insolvency of a major customer or the loss of a contract might have on our ability to continue?
- Are we able to pay our debts in full within agreed terms and does our forecast indicate that this position will remain so?
- Have we considered the working capital needs of our business, particularly if turnover is growing?

3.9 Conclusion

Notwithstanding that there are many questions still being asked about the latest proposals such as "Will it curb Phoenix activity?" and "Will the laws distinguish between Phoenix activity and legitimate business failure?" the government is clearly focused on utilising the DPN regime as a prime weapon in an attempt to address the problem of Phoenix activity.

The proposed increase in potential risk for Directors and/or Deemed Directors is significant so it is important that you understand the evolving DPN landscape or otherwise connect with an expert to help you advise your clients.

4 TAX ISSUES ON MEMBERS' VOLUNTARY LIQUIDATION

Companies are a statutory creation and as a result have an unlimited life in theory. However, once a company is no longer useful, the shareholders may look to deregister, wind up or otherwise dispose of the company.

In this instance we are focusing on the members' voluntary liquidation (MVL) option whereby the company is liquidated and the stored value is distributed to the shareholders.

Shareholder's wealth can be enhanced by adopting a course of action that legitimately allows access to the stored value in a tax effective manner. Careful planning and understanding the process and mechanics is critical in ensuring that tax effective access to the stored value becomes a reality. There can be a material difference in tax outcomes in distributing stored wealth from companies to shareholders. The liquidation option can result in significantly different tax outcomes as outlined below:

	Normal Distribution	**Liquidators Distribution**
Retained earnings	dividend	dividend
Pre CGT reserves	dividend	capital proceeds
50% Active asset reserve	dividend	capital proceeds
CGT indexation reserve	dividend	dividend
Paid up capital	capital proceeds	capital proceeds

The benefits of having distributions as capital proceeds as opposed to dividends include:

- Where the shares that the capital proceeds are in respect of are pre CGT assets of the shareholders there will be no tax payable on that part of the liquidators' distribution
- If the shares are post CGT assets, then they may be eligible to access either the general 50% CGT discount or the small business CGT concessions – resulting in significantly different tax outcomes due to the application of the concessional tax treatment (as opposed to being fully taxable as dividends)

4.1 Planning before the MVL

Before considering a MVL it is critical that the affairs of the company are reviewed and that the company is able to be placed into a MVL. Another consideration is whether any transactions are required to occur to get the company ready to enter the MVL.

An MVL involves the appointment of a liquidator to liquidate the company. The following is an overview of the process and requirements before this can occur:

- Being able to validly pass the required resolutions of directors calling for the shareholders to resolve to wind up the company, a key requirement of which is that the company must be solvent and a solvency declaration made
- Lodgement of the necessary forms and declarations with ASIC, including a statement of affairs outlining the assets, liabilities and expenses
- Shareholders meeting and resolving to wind up the company, again requiring certain declarations and forms to be prepared and lodged
- All of the above are subject to complying within strict timeframes

Based on our experience, it is rare that a company can be placed straight into a MVL without a review of the tax background and tax characteristics of the remaining assets and liabilities, and some tidy up of the balance sheet beforehand.

The following are the main types of considerations that we find require attention before entering a MVL can be started:

- Tax lodgements

    Part of the liquidation process involves obtaining a tax clearance from the ATO as part of the liquidation process. Liquidators also are required to notify the ATO of their appointment. As a result it is important that all outstanding company tax lodgements (for example FBT, GST Super Guarantee obligations and income tax etc) are up to date before the company enters a MVL.

    Tax obligations of companies do not cease just because it has entered liquidation, so tax liabilities on any asset disposals still need to be accounted for before the final tax clearance can be obtained. In fact Section 254 of the Income Tax Assessment Act 1936 requires a liquidator to prepare and lodge income tax returns for the period of their appointment. If assets need to be sold by the liquidator there may be tax and GST consequences to consider and factor in to any subsequent distributions by the liquidator.

    Tax clearance involves clearance in respect of income tax, FBT, GST and Super Guarantee requirements, amongst others, being sought from the ATO.
    Another important consideration is ensuring that the franking account is up to date at the start of the MVL. Any dividend distributions can be franked so it is important that the correct amount of available franking credits be quantified.

- Division 7A compliance

    The provisions of Division 7A continue to apply even though a company is placed into liquidation. As a result, before appointing a liquidator it is important that all of the required loan agreements, annual interest and repayment requirements etc have been complied with. Not having compliance in this area ‘up to scratch’ could defeat the whole reason for adopting the MVL as previous non-compliance could result on the loan amounts being regarded as deemed dividends in prior years. So what ordinarily could have been distributed as concessionally taxed capital returns is instead treated as fully taxed dividends. It also may be that there are no available franking credits that may be applied in cases where Division 7A deemed dividends arise that can be franked due to the nature of the transactions that can give rise to capital distributions on liquidation.
    A particular area where Division 7A is of a concern is where shareholders have accessed the cash in the company before seeking advice. While a liquidator can have an extra year to make loans that comply with Division 7A, this cannot be extended to cash taken by shareholders prior to the appointment of the liquidator. It is also open to argue that the taking of the cash is simply a dividends for the purposes of Section 44 of the Income Tax Assessment Act 1936, without ever getting to be able to access the Division 7A loan provisions that can effectively allow the dividend to emerge over a period of up to 7 years (where unsecured).

- Application of all available Small Business CGT concessions before the MVL

    Capital gains that can be concessionally paid from the company under the following Small Business CGT concessions should be accessed before entering a MVL:

    - Gains that qualify for the 15 year concession (Subdivision 152-B of the Income Tax Assessment Act 1997), and
    - Gains that qualify for the retirement concession (Subdivision 152-D of the Income Tax Assessment Act 1997)

    These amounts can be accessed from the company as cash payments either to the qualifying shareholder or to a superannuation fund of the shareholder. They will not be treated as dividends.

    The specific timing and payment rules for each of the concessions should be considered and complied with when accessing these amounts.

If the active asset concession of Subdivision 152-C of the Income Tax Assessment Act 1997 has been applied, then the amount of the concession should be appropriately recorded in the accounts so it is capable of separate identification from other components of the equity section of the balance sheet of the company. This usually entails the creation of a specific reserve for such amounts and the maintaining of detailed records to support the amounts contained in the reserve.

- Payment of any other concessionally taxed entitlements
  It should also be considered whether there are any other entitlements that can be paid out to terminating employees before the MVL commences such as:
  - Redundancy payments,
  - Employment termination payments,
  - Accrued leave entitlements,
  - Invalidity payments and
  - Superannuation contributions etc

4.2 Liquidators distributions

4.2.1 General

It is an established principle that a liquidators' distributions is a capital return[1]. However, this principle has been modified by Sections 47 (1) and (1A) of the Income Tax Assessment Act 1936.
Section 47 provides as follows:

Section 47 Distributions by liquidator

(1) **[Distribution other than to replace loss of paid up capital]** Distributions to shareholders of a company by a liquidator in the course of winding-up the company, to the extent to which they represent income derived by the company (whether before or during liquidation) other than income which has been properly applied to replace a loss of paid-up share capital, shall, for the purposes of this Act, be deemed to be dividends paid to the shareholders by the company out of profits derived by it.

(1A) **[Capital gain included in income of company]** A reference in subsection (1) to income derived by a company includes a reference to:

(a) an amount (except a net capital gain) included in the company's assessable income for a year of income; or

(b) a net capital gain that would be included in the company's assessable income for a year of income if the *Income Tax Assessment Act 1997* required a net capital gain to be worked out as follows:

Method statement	
Step 1.	Work out each capital gain (except a capital gain that is disregarded) that the company made during that year of income. Do so *without indexing* any amount used to work out the cost base of a CGT asset.
Step 2.	Total the capital gain or gains worked out under Step 1. The result is the net capital gain for that year of income.

(2) **[Distributions deemed paid out of profits]** Those distributions shall, to the extent to which they are made out of any profits or income, be deemed to have been paid wholly and exclusively out of those profits or that income.

(2A) **[Distribution otherwise than by company]** Where:

(a) the business of a company has been, or is in the course of being,

[1] DCT (NSW) v Stevenson (1937) 59 CLR 80

discontinued otherwise than in the course of a winding up of the company under any law relating to companies;

(b) in connexion with the discontinuance, any moneys of the company have been or other property of the company has been, on or after 19 October 1967, distributed, otherwise than by the company, to shareholders of the company; and

(c) the moneys or other property so distributed are not, for the purposes of this Act, dividends;

the distribution shall, subject to subsection (2B), be deemed to be, for the purposes of this section, a distribution to the shareholders by a liquidator in the course of winding up the company.

(2B) **[Company does not cease to exist within three years]** Where:

(a) subsection (2A) would, but for this subsection, apply in relation to any moneys or other property of a company distributed to shareholders of the company; and

(b) the company does not cease to exist within a period of 3 years after the distribution, or within such further period as the Commissioner allows;

subsection (2A) shall not apply, and shall be deemed never to have applied, in relation to those moneys or that other property, and those moneys or that other property so distributed shall, for the purposes of this Act, be deemed to be dividends paid by the company to the shareholders out of profits derived by it.

(3) **[Paid-up share capital exclusion]** For the purposes of this section, **"paid-up share capital"** includes capital which has been paid up in money or by other valuable consideration and which has been cancelled and has not been repaid by the company to the shareholders.

As a result, Section 47 will result in the following amounts being treated as income distributions in the form of dividends by the liquidator (which can be franked[2]):

- Income derived by the company
- Certain capital gains derived by the company calculated in a specific way

Common items that will represent income include the following examples:

- Profits from business activities
- Passive income from rent, dividends, interest and royalties

Capital gains are included where they relate to post CGT assets, but excluding indexation and reduction for capital losses. Importantly the following capital gains are excluded for these purposes:

- Gains on pre CGT assets
- Market value growth for assets that lose pre CGT status under Division 149 of the Income Tax Assessment Act 1997
- The 50% Active Asset reduction under Subdivision 152-C of the Income Tax Assessment Act 1997 (and predecessor provision amounts[3])
- Disregarded capital gains under the 15 year concession[4]

[2] Section 202-40 Income Tax Assessment Act 1997

[3] For example sections 160ZZR of the Income Tax Assessment Act 1936 and Section 118-250 of the Income Tax Assessment Act 1997 – See TD 2001.14

[4] Subdivision 152-B of the Income Tax Assessment Act 1997

4.2.2 Tax effective distributions

The following guide is recommended for the liquidation process.

4.2.3 Apply the Archer Brothers principle

The Archer Brothers case[5] is a landmark decision in relation to liquidators' distributions. It established the principle that a liquidator can make distributions out of specific sources of profit or gain. However, in order to be able to do this the accounting records must be able to separately identify the source from which the distribution is made.

The ATO has accepted that this is possible in TD 95/10, but adds the following conditions:

- Appropriate accounting records are maintained that establish the identity an amount of the profit or gain that is being distributed, and
- This profit or gain is distributed by the liquidator – and that this can also be shown to be the case

Conversely, if the records do not exist that can enable the application of the Archer Brother principle, then the entire amount, or a proportion of it[6], will be treated as a dividend rather than as a capital distribution.

The reliance on this principle adds further weight to the need to do some housekeeping before entering the MVL process. Ideally the accounting records would have correctly recorded the various sources of profits that could potentially benefit from the application of the Archer Brother principle on any future MVL from the time they are first recorded in the accounts. However, failing that it may still be possible to reconstruct the amounts based on a review of prior year records prior to the MVL process starting[7]. In both cases, appropriate records should be in place to show the sources of the specific gains or profits to which the Archer Brothers principle is to be applied.

The following categories of income or profit normally exist:

- Retained profits (including post CGT taxable gains)
- Pre CGT gains (including any relevant Division 149 market value uplift)
- 15 year exemption amounts
- 50% Active asset concessions amounts

4.2.4 Identify and quantify

Once the Archer Brothers principle is capable of being applied, identify and quantify the various amounts to be distributed.

Under the Archer Bothers principle, the various sources of profit or gain are distributed in the order chosen. Once the sources are exhausted, any remaining amounts are ignored as there are simply no more funds to be distributed.

Distributions are normally made in the following order:

- Paid up capital and credit loan balances, then
- Capital amounts (amounts not caught under Section 47), then
- Amounts recognised as dividends under Section 47

[5] Archer Bros. Pty Ltd (in Vol. Liq) v FCT 1953 90 CLR 140

[6] For example a pro rate apportionment was found to apply in Resch v FCT (1942) 66 CLR 198

[7] Glenville Pastoral Co Ltd v FCT (1963) 109 CLR 199 is authority for the position that such recording of funds must occur before the MVL begins

4.2.5 Make distributions

As a guide, the following tax consequences will arise for shareholders in respect of the various components:

- Dividends
  - Retained earnings (trading profits, net passive income profits)
  - Profits on isolated profit making transactions
  - Gains above the deemed market value cost base where Division 149 of the Income Tax Assessment Act 1997 has been triggered
  - Post CGT gains not excluded below
- Capital amounts
  - Paid up capital
  - Pre CGT reserves (but note Division 149 issues)
  - 50% Active asset component
  - 15 year concession
  - Other excluded gains (former goodwill concessions etc)

For the dividend component, any available franking credit should be attached to the distribution. The liquidators distribution needs to provide the required information on the distribution statement in respect of the franking of such distributions.

For the capital component there are further considerations to be considered. Specifically, the receipt of such amounts may give rise to capital gains at the shareholder level.

The CGT event that will normally apply is CGT event C2[8]. This event will not arise on the distributions. Rather it will arise on the ending of the asset. This is not at the time of entering into the MVL or on the payment of the distribution. Rather it is at the time the shares are regarded as ceasing to exist. The Corporations Act provides that this occurs 3 months after the final meeting convened by the liquidator[9]. Accordingly the application of the timing rules for the taxing of any capital gain should be considered as part of the MVL planning process. Please note that where interim distributions are made, CGT event G1[10] can apply where the payment arises more than 18 months before the company is deregistered as part of the liquidation process. The time of this gain is when the payment is made. It essentially becomes a timing issue, but the timing may be important for planning when tax liabilities arise.

For pre CGT shares there will be no tax implications for the shareholder in respect of the liquidators distribution. If the shareholder is a company, then the analysis process for any subsequent distribution of funds from that company is required.

It is a common misconception that distributions from pre CGT reserves are tax free to shareholders. The correct analysis is that the distributions in respect of such amounts are consideration for the cancellation of the shares. If the shares held by the shareholder are pre CGT shares, then any capital gain is disregarded[11]. If the shares are post CGT shares, then a capital gain can arise under CGT event C2.

Where the shares are post CGT assets held by individuals, trusts or Superannuation funds, the application of the general 50% discount[12] for shares held for more than 12 months should be considered. Further CGT event C2 is not one of the CGT events that are excluded from accessing the discount[13].

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[8] Section 104-25 of the Income Tax Assessment Act 1997

[9] Refer Section 509 of the Corporations Act 2001

[10] Refer Section 104-135 of the Income Tax Assessment Act 1997

[11] Refer Section 104-25(5)(a)

[12] Division 115 of the Income Tax Assessment Act 1997

[13] Refer section 115-25(3) of the Income Tax Assessment Act 1997

As an alternative, or in addition, the capital gains may be eligible to access the small business CGT concessions of Division 152 of the Income Tax Assessment Act 1997. Specific reference should be had to the provisions to determine what, if any, of the concessions can apply. The most relevant considerations are as follows:

- Identifying any significant individuals and CGT concession stakeholders
- Passing the basic conditions for the application of the concessions
    - Maximum net asset test or the small business entity conditions
    - Active asset test
        - This requires consideration at the planning stage of the MVL given the time period requirements of this test[14]
        - The shares need to be active for more than half the required period or 7.5 years – whichever is the less
- Identifying the available concessions and their specific requirements
    - The available concessions are[15]:
        - The 15 year exemption
        - The 50% active asset reduction
        - The retirement concession and/or
        - The replacement asset concession

4.2.6 Liquidators fees

As a final consideration, the question as to the deductibility of the costs of liquidating the company should be considered.

The cost of liquidating the company are capital expenses and as a result will not be directly deductible under Section 8-1 of the Income Tax Assessment Act 1997.

The only provision under which a deduction can be claimed is Section 40-880 of the Income Tax Assessment Act 1997. This is commonly referred to as the ‘blackhole expenditure’ deduction.

Section 40-880 will allow the liquidators fees to be deductible over 5 years (20% of the costs in each year) where:

- The expenditure has not otherwise been taken into account
- A deduction is not denied by another provision, and
- The business was carried on for a taxable purpose

Specifically, Section 40-880(2)(d) provides as follows:

> **(2)** You can deduct, in equal proportions over a period of 5 income years starting in the year in which you incur it, capital expenditure you incur:
>
> > **(d)** to liquidate or deregister a company of which you were a *member, to wind up a partnership of which you were a partner or to wind up a trust of which you were a beneficiary, that carried on a business.

A further condition is set out in Section 40-880(4) as follows:

> **(4)** You can only deduct the expenditure, for a *business that another entity used to *carry on or proposes to carry on, to the extent that:
>
> > **(a)** the business was carried on or is proposed to be carried on for a *taxable purpose; and
> >
> > **(b)** the expenditure is in connection with:
> >
> > > **(i)** your deriving assessable income from the business; and
> > >
> > > **(ii)** the business that was carried on or is proposed to be carried on.

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[14] Refer Section 152-35 of the Income Tax Assessment Act 1997

[15] Refer to Division 152 of the Income Tax Assessment Act 1997 for all the concessions and conditions

As a result, where the shareholder incurs the liquidators fees in respect of a MVL for a company that was carried on for a taxable purpose and the shareholder was capable of receiving dividends (so no application for voting only shareholders, a deduction for the liquidators fees will arise under Section 40-880.