

## Tax Brief

14 January 2009

### **Insolvency & workouts: GST matters (with or without personal liability)**

As the world economy struggles to find its way through troubled times, many businesses find their financial condition deteriorating leading, unfortunately, to formal insolvency appointments for some.

However that situation plays out, the GST treatment of asset sales and other workout solutions will be crucial in determining what funds can be generated to meet the demands of creditors.

The purpose of this tax brief is to outline the GST issues arising from the appointment and subsequent activities of trustees in bankruptcy, receivers/managers, administrators or liquidators (each termed a "Representative of an incapacitated entity" under Division 147 of the GST Act).

In particular, we focus on the GST obligations and entitlements of Representatives within the terms of the basic provisions of the GST Act if and as modified by Division 147.

#### **No Personal Liability (yet): *PM Developments***

The drafting of Division 147 is far from satisfactory. Section 147-1 provides that what Division 147 is "about" is simply "Representatives of incapacitated entities may be required to register for GST".

The terms of Division 147 require just that. But a key term is missing. While Representatives are required to register for GST in that capacity, nothing in Division 147 (expressly) makes a Representative liable for GST. The only provision dealing with GST liability is section 147-20 which allows a Representative to give notice to the Commissioner that a pre-appointment adjustment is properly that of the incapacitated entity (arguably therefore implying that the adjustment would ordinarily be that of the Representative, perhaps implying that the representative should be liable for post appointment GST liabilities).

Much debate has therefore ensued as to whether a Representative is personally liable for taxable supplies made after its appointment or whether that GST is properly a (post appointment) debt of the company for which the Commissioner must rank with other creditors. The crux of the issue is whether personal liability for the Representative gives the Commissioner a

de facto priority over other creditors who must look to the assets of the Company for satisfaction.

While the flaws of the drafting have been highlighted regularly, the Commissioner has preferred a “purposive” interpretation, drawing comfort from the Explanatory Memorandum that personal liability for Representatives is an inference the courts should draw (see ATO publication “Representatives of Incapacitated Entities”).

Round one in that battle has been fought. Taking a robust and direct approach in the Federal Court case of *PM Developments* [2008] FCA 1886, Logan J has found that because Division 147 does not expressly make a Liquidator personally liable for GST on supplies made in that capacity, that liability falls to the Company. As a result the Commissioner ranks with other creditors in accordance with section 556(1)(a) of the *Corporations Act*.

## Background

The facts in the case were relatively simple and not in contention:

1. PM Developments Pty Ltd (**Company**) owned new residential premises. It experienced financial difficulties and a Liquidator was appointed by the Federal Court on application by the Commissioner of Taxation (presumably on the basis of other unpaid tax liabilities).
2. The Liquidator sold the property as the taxable supply of “new residential premises” for GST purposes.
3. There was no dispute between the parties that GST was payable on the sale. The only question was whether that GST liability was personal to the Liquidator or was a liability of the Company. The difference is that the Commissioner would be paid the GST in full by the Liquidator if it were a personal liability but only a proportion of it if the Company were liable, after taking into account other creditors’ claims.
4. The Liquidator sought a private ruling. The Commissioner ruled that pursuant to Division 147 of the GST Act the Liquidator was personally liable (ie applying the Commissioner’s preferred “purposive” approach).
5. With test case funding provided by the Commissioner, and having paid the GST amount into trust, the Liquidator applied to the Federal Court for declaratory relief to the effect that the GST payable on the sale of the property was a debt due and payable by the Company and not a liability personal to the Liquidator.

So, the case was therefore decided almost entirely on the interpretation/operation of Division 147 of the GST Act. In the course of his decision, Logan J made a number of telling observations:

1. On appointment pursuant to section 474(1) of the *Corporations Act* the Liquidator takes the assets of the Company into his/her custody or control. Importantly, and unlike a Trustee in Bankruptcy, nothing in the *Corporations Act* vests the asset in the Liquidator – the Company

retains title at all times (unless an order to the contrary is sought from the Court).

2. While the Liquidator displaces the directors of the Company, this merely imposes the duties and powers of the directors on the Liquidator. The Liquidator does not displace the Company (ie the Company continues to own its assets and operate its business, albeit under the direction/control of the Liquidator).
3. In determining whether a taxing provision applies, “clarity of language” in the provision rather than “inexactitude or indirect references” is needed to impose tax. This is particularly the case where there is no suggestion of tax avoidance and the proposed interpretation imposes tax on a person (eg the Liquidator) in a manner contrary to the usual tax position and the prevailing general law.
4. Because the section 9-5 definition of “taxable supply” is predicated on an entity (“you” in the language of the GST Act) making a supply, care must be taken in identifying that entity.
5. While Division 147 requires a Liquidator to register for GST purposes, there is nothing to expressly make the Liquidator liable for GST (ie the Liquidator must be the relevant “you” for the purposes of section 9-5 to have a GST liability). Further there is nothing in Division 147 to expressly reverse the general law/*Corporations Act* position that the Company retains title in the assets and must therefore be the entity making the supply.
6. While the Explanatory Memorandum for Division 147 might indicate that personal liability for the Liquidator was the statutory intention, statements to that effect are incorrect in the face of the provisions for Liquidators (but not Trustees in Bankruptcy) and that legislative amendment would be necessary to give effect to that intention.

On the basis of the above , because the assets of the Company are not directly vested in the Liquidator and in the absence of an express deeming to the contrary, any taxable supplies effected by the Liquidator must be “made” by the Company meaning that the GST on those supplies is a liability of the Company, not the Liquidator.

While the decision was based on a liquidation scenario, given the terms of Division 147, it is likely that a similar situation would be found to apply to other Representatives such as privately appointed receivers where they have control of but not title to the assets of the incapacitated entity. By contrast where the Representative has title to the assets of an insolvent person (such as a Trustee in Bankruptcy), it is likely that the Representative is liable for the GST though the judge did not have to express any concluded view on this issue.

Given that this is a complete reversal of the Commissioner’s position, it might be expected that the Commissioner would appeal. However, while the ATO expects to publicise its position on Logan J’s decision, any appeal and the administration of Division 147 by “mid-January 2009”, we understand that an appeal is unlikely. Given the strength of Logan J’s approach and

decision it may be, as recommended by Logan J in his decision, that a legislative amendment to expressly make Representatives personally liable is the most likely outcome.

The previous Government announced legislation to clarify the matter in the 2005 Budget but no action has yet been taken and in the 2008 Budget the current Government indicated that no decision had been taken by it on the issue. In 2008 the Board of Taxation reviewed various issues with the administration of GST and sought views on the tax treatment of incapacitated persons. The Board's Report is currently with the Government but no decisions have yet been announced.

If the government does amend Division 147, it will need to consider whether such an amendment is purely prospective, its impact on prior transactions and the potential for refunds due to Representatives that have paid GST in their personal capacity (subject to the application of the *Taxation Administration Act 1953* refund provisions).

This of course leaves Representatives in an invidious position until the ATO's formal view on the decision and its impact is announced and the Government makes a decision as to a legislative response.

On one side there is a very clear decision of the Federal Court stating that the GST is payable by the Company. On the other, the Commissioner is equally clear in his view that the Liquidator should meet all GST obligations and may recommend that the Government seek legislative change to give effect to that position. In the middle are the other creditors and the Representative's obligations to them – what risk will a Representative be exposed to in adopting one position or the other?

## **Practical implications**

As a result of Logan J's decision, secured creditors will prefer (at least so far as GST is concerned):

1. The formal appointment of a "Representative" so that all funds realised from asset sales are paid to the creditors rather than being used in part to pay GST.

This approach is not available for mortgagee in possession sales (mortgagees remain personally liable for GST under Division 105 which has the express deeming found to be missing from Division 147 in *PM Developments*) meaning that the administrative simplicity of such sales needs to be weighed against the GST "Cost";

2. Assets to be sold by way of taxable supply rather than non-taxable (eg going concern) or partly taxable (eg applying the margin scheme to some property sales) as the funds realised (including GST) will be maximised.

Finally Representatives will no doubt need to carefully weigh their duties to creditors and the company in determining the GST position to be adopted.

## **GST Administration: appointment of a Representative**

So, while the decision in *PM Developments* will be welcomed by many, it does lead to some uncertainty as to just what payment obligations Representatives have. However, certain other compliance consequences are clear as a result of the appointment:

1. The Entity needs to lodge “concluding tax period” BAS up to appointment (ie a stub return).
2. Representatives must register for GST in that capacity – the ATO will add a Client Activity Centre (CAC) to the pre-existing Entity ABN.
3. On the ATO’s preferred view, the Representative (effectively) becomes a new taxpayer separate and distinct from the incapacitated entity. It must therefore lodge a BAS for tax periods commencing on its appointment and is personally liable for the GST obligations that arise post appointment.
4. In contrast, Logan J would say that while the Representative might have compliance obligations (such as lodging a BAS), the GST liability can only be recovered against the Entity and that the BASs are those of the Entity.
5. Partial appointments (eg Receiver of only some assets) mean that both the Entity and the Representative have separate GST liabilities (ATO view). However, on the *PM Developments* view, while the Representative must lodge GST returns and meet other obligations for the relevant assets, liability for the underlying tax remains with the Entity.
6. Pursuant to section 147-20 “adjustments” (eg for bad debts or price alterations as well as “change in use” adjustments) fall to the Representative unless a notice is given to the Commissioner.
7. On cessation of the appointment, the Representative must deregister (requiring a part period BAS) and the Entity, assuming it continues, once again becomes fully responsible for its GST affairs.
8. If the Entity was a member of a GST group, the Representative (going forward as GST registered via the CAC indicator) must generally exit the GST group. This has the effect that intra-GST group transactions in the month of appointment must be recognised (ie in the stub return for the concluding tax period).
9. As important as the *PM Developments* decision might be for many insolvency practitioners, a number of problems with Division 147 were not addressed:
  - It is unclear how the GST timing/attribution rules interact with the appointment of a Representative. Does a liability fall into the post appointment period if that is when attribution occurs even though the supply occurs pre-appointment?

In this regard, the Commissioner applies the attribution rules rigidly in the case of entities moving into or out of GST Groups.

- To what extent is/can the Representative be bound by or rely on other provisions in the GST Act which require the agreement of the Entity (eg Division Div 83 reverse charge and Subdivision 153-B agency arrangements)?
- Is a Representative bound by a Recipient Created Tax Invoice Agreement?
- Is it the case, as is generally accepted, that the Representative is entitled to use the margin scheme for real property sales on the same basis that the Entity would have been?

In relation to these last three issues, on the reasoning of Logan J in *PM Developments*, a Representative is acting as and for the entity so it should be bound by, or able to utilise, the same GST agreements and provisions that the entity was bound by or could utilise.

Until the Commissioner either accepts the decision, an appeal is lodged or clarification of the legislative drafting is announced, Representatives are left in the uncomfortable position of having a Federal Court Judge deciding they don't have a personal GST liability, but the Commissioner so far insisting they do.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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