Practice Alert

Director Penalty Notices

Introduction

Personal Liability notices are an extremely powerful and effective debt collection tool available only to the **Australian Taxation Office.** They allow the ATO to impose personal liability on company directors without the delay or expense of taking legal action. For this reason, it is essential that company directors act promptly if they receive a **Director Penalty Notice.** However, while it is easy to conclude that company directors must act quickly if they receive a notice, they must choose their course of action carefully. Although paying the amount of the notice may appear to be the simplest and most direct response, as we will explain below it may actually result in a significantly larger personal liability in the future.

How the Notices work?

If a company falls behind in its payment of tax liabilities, the ATO can issue a Director Penalty Notice to any or all of the directors. The notice take the form of a letter from the ATO.

Once they are received, company directors have fourteen (14) days to implement one of four alternatives:

< Pay the debt in full; or
< Agree and implement an instalment payment with the ATO; or
< Ensure that the company is being wound up; or
< Place the company in voluntary administration.

If one of these four outcomes is not achieved within the fourteen day period, then the Income Tax Assessment Act imposes personal liability on directors for the amount as set out in the notice.

Pay the debt in full

Ensuring that the company pays the debt is the most obvious way of dealing with a Director Penalty Notice - but depending on the circumstances it may not be the best alternative.

If the company is later wound up - despite the best endeavours of directors - then the liquidator will scrutinise any payments to creditors, and attempt to clawback any potential 'unfair preferences.'

Unfair preferences are governed by specific provisions of the Corporations Act - but briefly, they are transactions that provide a creditor with part or full payment that is not available to all creditors, and they can be recovered or 'clawed-back' by a liquidator in specific circumstances. If the liquidator is able to recover unfair preferences paid to the ATO, then section 588FGA of the Corporations Act allows the ATO to seek reimbursement from the directors of the company, unless the directors can establish one of the statutory defences. The statutory defences are similar to those available against insolvent trading claims, if a director:

- Had reason to believe that the company was solvent; or
- Had taken 'all reasonable steps' to stop the transaction; or
- Was not involved in the management of the company for 'good reason'; or
- Had believed that the company was solvent because of the advice of a 'competent and reliable person.'

CASE STUDIES

Gibbons & Anor v Deputy Commissioner Taxation illustrates how the clawback indemnification works.

The liquidators of a company took action to recover unfair preferences totalling more than $821,000 from the ATO.

The ATO admitted receiving the payments, but argued that the company was not insolvent at the time the payments were made. In addition, the ATO crossclaimed against the director, so that if the liquidators were successful, it could seek an indemnification order from the director.

The director likewise argued that the company was solvent when the payments were made, and also argued that he was entitled to various statutory defences - namely that he had reasonable grounds to believe that the company was in fact solvent, that he had reasonable reliance on another person which led him to believe that the company was solvent, and that there were no reasonable steps that he could have taken to prevent the company from making the payment.

The New South Wales Supreme Court ruled that the director's assertion that the company was 'sound and thriving' was 'implausible' - in fact, the director had clear reason to be concerned about the financial position of the company.

Practice Alert

Director Penalty Notices

Finding that the director had a clear responsibility to manage 'matters relevant to solvency,' and properly address insolvency once he became aware of it, the Court held that the liquidator was entitled to recover the payments from the ATO, and that the director was liable to reimburse the ATO.

Because payment can be clawed-back thereby triggering the statutory right of indemnity, paying the debt may not necessarily be the most appropriate course of action unless directors are certain that their company will remain solvent.

Negotiate an instalment arrangement

Negotiating an installment arrangement with the ATO that will resolve the question of personal liability, to a point.

However, if the company later breaches the arrangement then anyone who acted as a director between the time when the agreement was reached and the date it was breached can be made personally liable under another similar provision of the Tax Act.

For that reason, installment arrangements are only appropriate where the directors have a high level of confidence that the company will fully comply with the agreement. In practice, the longer the time period covered by the agreement, the greater the risk.

If this option is under consideration, one should bear in mind that the payment arrangement must be in place before the end of the fourteen day period, merely commencing a negotiation is not enough.

Place the company into liquidation or voluntary administration

If an instalment arrangement or paying the debt in full is not possible or appropriate, then directors should very carefully consider appointing a liquidator or administrator.

It is important to note that the company must be in liquidation within the fourteen day period - to commence a voluntary winding up application which is finalised outside of that fourteen day window is not enough. Directors should be aware that it takes at least 7 days to initiate a voluntary liquidation.

If the notice has been received late and you don't have a clear 7 days to initiate a voluntary liquidation, Voluntary Administration may be the only viable option. Directors can immediately appoint a Voluntary Administrator who has consented to act.

What should directors do if they receive a Personal Liability notice?

Unfortunately, there is no simple answer to this question because it will depend on the company's financial position and circumstances.

However it is clear that directors who receive such a notice must:

Act quickly,

Make decisions based on the company's overall financial position and viability; and

Chose a course of action that is viable in the long term.

Typically this will require specialist assistance. If you wish to appoint a voluntary liquidator or voluntary administrator please call CRS Insolvency Services on 1800 210 073 for urgent assistance.

Notes: