



AN INTRODUCTION TO THE TAXATION EFFECTS OF EXTERNAL ADMINISTRATION

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INTRODUCTION

This paper has been prepared to give an overview of the taxation consequences of distributions in insolvent liquidations and in solvent liquidations.

Like many other areas of tax law, the provisions dealing with distributions in external administration are complex and require a detailed understanding of the interaction of the law on the one hand, and a careful analysis of the history of the commercial transactions of the taxpayer company.

The legal provisions and are located across a wide range of the provisions of tax legislation.

As this paper is intended to be read by non-specialist practitioners, I have omitted reference to certain issues likely to arise only in the case of very large companies, or those with very complex taxation affairs. In particular I have omitted reference to non-commercial debt defeasance; the taxation consequences of debt for equity swaps; and rules applicable to limited recourse lending. None is likely to complicate greatly the tax position of a liquidation, although they may be relevant in the case of reconstruction and to the position of holders of interests in a liquidation such as creditors and members.

BACKGROUND

The return of capital in a solvent liquidation is the end for most of the company's trading, other than the realization of assets and crystallization of liabilities. It follows that virtually any issue that may present in the relationship between the taxpayer and the revenue authorities can arise (and hamper) such a distribution. However, it would be pointless to attempt to essay the entire breadth of the complexities of Australian taxation law.

I outline the consequences of "straightforward" transactions of the type likely to be encountered in the administration of companies that have not engaged in sophisticated tax planning transactions and which are comparatively straightforward. Allowing that these cases are "straightforward", there are still matters of considerable complexity that require elaboration, resting chiefly on:

- The residency of shareholders (it is assumed that the company is Australian resident)
- The position of the company's franking account, reflecting its history of tax and dividend payment since the introduction of dividend franking
- Whether the company is part of a corporate group, and if so, whether the group has elected to consolidate for tax purposes
- Whether, if the company is part of a tax consolidation group, it is party to a tax sharing agreement
- The structure of the company's capital accounts, and in particular:
 - Whether the share capital account has been "tainted"
 - Whether the proprietorship accounts record either carry forward revenue or capital losses
 - Whether the accounts show disaggregated capital gains or losses realized with respect to pre-CGT assets

- The company's trading history, and in particular whether it has accumulated revenue gains or losses, and to the extent that it has retained revenue gains, whether those gains were derived in Australia or abroad;
- The company's business, in particular whether three-quarters or more of the value of its assets (at appointment) comprise real property
- The effect (if any) of double-taxation agreements.

For the sake of simplicity, I will be ignoring:

- Goods and Services Tax (there is a separate regime for GST grouping and insolvency);
- PAYG withholding applicable to employment, except in passing;
- "Trade On" liabilities; again, except in passing, and
- The many resource rent and transactional taxes levied by the Commonwealth and State governments.

The taxes

The two principal taxes of concern are the tax on income and tax on net capital gains. The structure of ITAA36 and ITAA97 are such that net capital gains are deemed to form part of assessable income, however the anti-double taxation provision (section 118-20 of ITAA97) and the operation of separate tax-loss rules, together with the historically quite different treatment of gains made on revenue and capital account make it convenient to consider the taxes separately.

Because of the longevity of many businesses, and the quarantining of legacy tax benefits, it is necessary to refer to a range of issues which are no longer applicable to income/gains derived in modern business. An important example is the considerable value of residual pre-1985 assets, gains on which will not now generally be assessed as giving rise to capital gains tax. Because of possibilities for roll-over relief, the benefit of these tax concessions is and is likely to remain an important aspect of Australian tax planning.

Franking

Franking is the cornerstone of the dividend imputation scheme which avoids "double taxation" of income earned by resident companies paid by way of dividend to Australian resident shareholders.

In simple terms, the company obtains "franking debits" by paying income tax on its own profits in proportion to the tax paid. When paying a dividend (whether before or after an external appointment) it then "distributes" "franking credits" in proportion to the distribution, calculated as a credit at the prevailing corporate income tax rate. The recipient includes the combined value of the distribution and the franking credit in its assessable income, and obtains a credit against any tax liability equal to the value of the franking credit.

This way, corporate income is taxed at the marginal tax rate of the shareholder.

If the dividend recipient is a non-taxpayer or has surplus or “excess” franking credits (for example it is a charity, a superannuation fund (whose income is taxed at a concessional rate) or a low personal income earner) it receives a refund with respect to “unused” franking credits from the ATO. The scheme applies to “complying” superannuation funds (the usual retail, industry and corporate funds, as well as many self managed funds, taxed at 15% on income) but not to non-complying funds, which neither qualify for concessional taxation rating nor the benefit of excess franking credit refunds.

FUNDAMENTAL PRINCIPLES OF TAXATION AND EXTERNAL ADMINISTRATION

- While the appointment of a liquidator changes control of the company and, by changing the control of the company can affect the availability of carried forward losses (on which more is said below), it does not separately trigger or relieve the company of any tax liability.

The main qualification to this principle is that the change of control effected by appointment disqualifies the company from satisfying the “continuity of ownership” test, so that past losses can only be offset against income or capital gains derived from the conduct of the company’s pre-appointment business, that is, by satisfying the “continuity of business” test.

- Although often overlooked, the company remains liable to lodge returns. However, in the case of insolvent entities, the ATO has agreed with the IPA that when considering whether to require completion of pre-appointment returns, it will consider:
 1. The prospect for, and likely size of, a dividend being paid to unsecured creditors;
 2. The likelihood that the return would, if lodged, reveal an increase in the tax liabilities owed to the Commissioner;
 3. The availability of books and records of the company taxpayer which would make it possible for the liquidator to prepare the returns;
 4. The likelihood that the liquidator’s cost of preparing those returns would be covered by the assets of the liquidated company without resulting in an inordinate adverse impact on returns to other creditors; and
 5. The wider community benefits of having the tax returns lodged.

Application of these principles should avoid the preparation of futile tax returns.

- The liquidator is required to notify the ATO of the appointment. The ATO is obliged to reply identifying the “tax related liabilities” of the company, a process called “clearance”. Until the ATO has provided clearance the liquidator must not part with funds of the company. Once clearance is obtained, the liquidator must retain sufficient funds to pay a rateable proportion of the amount payable to creditors to the ATO. Typically clearance is uncontroversial in an insolvent liquidation.

In a solvent liquidation the clearance process is the ATO’s last practical opportunity to prevent distribution of a fund against which it may have a claim. Where the ATO has doubt about the sufficiency of a taxpayer’s disclosure or treatment of transactions, clearance may take months or even years to obtain, normally frustrating the purpose of the liquidation. Obtaining tax clearance in a complex solvent liquidation will often involve disclosure of the proposed mechanism and form of distribution (including the terms of the liquidator’s accounting for the assets); where the ATO will remain comparatively well protected (such as where assets are distributed as money or money’s worth cash to resident shareholders) clearance will be easier to obtain. Where *in specie* distribution of assets, especially those that are difficult to value, is proposed to non-resident shareholders, clearance will generally be more difficult to obtain.

- A company can “enter” and “exit” a tax consolidation group.

So long as it is a member of the group:

- Transactions between the taxpayer and third parties are attributed to the “head company”; and
 - Transactions between the taxpayer and other members of the group have no tax consequences: these are essentially treated as “self dealing”.
 - It is either jointly and severally liable with the other members for the group’s taxation liabilities, or, if a Tax Sharing Agreement is in place, it is liable in accordance with the terms of that agreement.
- When a member of a consolidated group enters into liquidation it does not automatically leave its tax sharing group. However, on deregistration or alienation of any ownership interest in it, it will do so. On departure, an adjustment is made in the taxation position of the head entity for the net effect of the non-tax liabilities and assets that leave the group. The departing entity does not resume the tax position it formerly had, rather its tax position will be determined at the point of exit from the group. On exit its franking account balance is eliminated. Ordinarily, the exiting entity can be thought of as beginning afresh with an endowment of assets and liabilities, free of taxation obligations.
 - Where a transaction (such as distribution) occurs in relation to an asset which does not have a market value (either because its cost cannot be determined, or because it is not measured in money), the Sub-division 960-S of ITAA97 requires that the asset have attributed to it the “market value”, a term defined in the act to have its “ordinary meaning”. In determining that value, anything that would prevent conversion into money is disregarded.
 - As with any taxation question, a scheme designed predominantly to obtain a taxation benefit may fail by operation of Part IVA of ITAA36. While schemes have been effected through liquidation, it is not possible to consider the wide scope of the operation of Part IVA in this paper.

SINGLE ENTITY

Insolvent Entities

In referring to an insolvent entity, I intend to refer to one where the liabilities to which it is subject exceed the realisable value of the assets, such that there is to be no distribution to the members of the company (although they may have claims as creditors).

In most cases entities in insolvent administration have, or are expected to have, accumulated tax losses resulting from unprofitable trading. This means that any gains realised upon realisation of company assets will be absorbed (whether this is accounted for to the ATO or not) by accumulated pre-appointment and/or post-appointment tax losses. On this basis, the usual practice is that obligations to file income tax returns (which are not extinguished by external administration) are ignored.

In consequence, in most cases of insolvent administration, there is no issue of complexity with the tax position of the company. Once the liquidator has advised the ATO of his/her appointment, and, if necessary, brought the attention of the ATO to any discrepancy between historical returns and the company's dealings, the liquidator will have discharged his duty to the ATO with respect to the company's own taxation liabilities.

The company remains liable for taxation liabilities accruing during the liquidation, although the effect of any transactions occurring before liquidation will give rise to a claim to prove rather than a right to immediate payment. The company still accrues post-appointment liabilities, for example for capital gains tax and tax on any trading profits. As these are typically nominal it is uncommon for the company in liquidation to accrue a tax liability during liquidation. However, in the very large liquidation administrations it is common to continue to file tax returns; indeed some leading cases in tax, such as the High Court's decision in *Linter Group*, have resulted from this practice.

It is more common for the liquidator to be required to comply with the withholding provisions. The Liquidator will be required to withhold both from expenses directly incurred during liquidation (such as wages) as well as from some amounts paid by way of dividend.

When paying a dividend, the main withholding requirements are:

- Amounts subject to the PAYG (Withholding) regime; principally payments of dividend with respect to unpaid wages, payment in lieu of notice, and for leave (an "employment dividend");
- Amounts paid by way of dividend to creditors who are not Australian residents with respect to interest or royalty claims;
- Amounts paid by way of dividend to creditors in relation to taxable supplies where no ABN has been quoted.

When withholding from an employment dividend, the practitioner most frequently withholds at a rate of 31.5%, or 30% for non-resident employees. The practitioner has an obligation to obtain Tax File Numbers and/or Withholding Declarations, failing which he should withhold at 46.5% or 45%.

When making a payment to a non-resident creditor, the liquidator will be required to withhold 10% for so much of the claim as relates to interest; and 30% for so much as relates to royalties.

In addition, there are procedural penalty withholding regimes. In the uncommon case where a creditor claims payment with respect to a transaction that would be a creditable supply but for failure to provide a tax invoice, the liquidator must withhold 46.5%. Where the liquidator pays a dividend with respect to an investment where neither an ABN or nor TFN has been disclosed, the liquidator must similarly retain 46.5%.

As any dividend must necessarily be paid in cash, there are no valuation issues as regards the extent of the benefit received by the creditor.

Shareholders in insolvent entities are entitled to claim the loss incurred on their investment in shares. If held as trading stock, the claim can be made on appointment; if not, it can be made as soon as the liquidator has declared that there is unlikely to be a distribution to shareholders. The latter procedure avoids any possibility of a distribution being brought to account as income. The position with returns arising from claims for non-disclosure, that is a "*Sons of Gwalia*" claim is unclear.

Further information concerning the position of insolvent entities is available from the ATO's Insolvency Practitioner portal.

Solvent Entities

The taxation position of solvent entities is considerably more complex. The liquidator's purpose will normally be to effect a prompt distribution of the assets of the company (after discharging any outstanding liabilities) to the shareholders.

The point of distribution is in many respects the fulcrum upon which much Australian taxation law is based. In particular, the concessional treatment attracted by long-held assets acquired before September 1985, can be an important asset of the debtor, and the maximization of the benefit of which is a major motivation.

Whereas payment of a dividend to creditors is universally made by payment in money, the distribution of assets by the liquidator of a solvent entity to creditors, and more importantly, shareholders, often occurs by way of "in specie" distributions of particular corporate assets. These can include a distribution of real property (for example, an outright transfer of land, or less commonly a leasehold or life interest); the transfer of valuable goods, by transfer of choses in action (for example, shares), or by transactions whose operation is to destroy an asset (for example, an in specie distribution of a loan due from the recipient, where, provided there is strict mutuality of interest, the distribution will extinguish the liability).

Distributions of Income

Distributions made from "income" (typically from the accumulation of ordinary income in the retained profits account, but also from other revenue reserves, as well as from statutory income (for example royalties deemed to be income by section 10-15 of ITAA97) and exempt income (such as some income of Life Assurers) are be deemed to be dividends (and consequently income in the

hands of the recipient) by the combined operation of sections 44 and 47 of the ITAA 36, regardless of whether they would be of a capital or income nature in the recipients' hands on first principles.

A liquidator's dividend from income can be frankable so that resident shareholders are entitled to claim a franking credit. The liquidator is required to prepare franking accounts and provide the shareholders with a Distribution Statement recording the amount of the franking credit appropriated to the dividend. Resident shareholders incorporate franking credits in their personal tax assessment and receive a rebate to the extent of the credit. Where a distribution is not fully franked, the extent of the franking deficit will create a taxation liability on the part of resident shareholders.

The liquidator is required to withhold from unfranked dividends paid to non-resident shareholders at a rate of 10% unless varied by a Double Taxation Agreement.

Certain distributions made before liquidation are deemed to be dividends as an anti-avoidance device; examples are section 108 and Division 7A of ITAA36, which relate to uncommercial loans to shareholders and directors. In general, dividends deemed such by anti-avoidance legislation do not give rise to a franking credit in the hands of the recipient. Division 7A does not apply to a liquidator's distribution; however section 108 may apply. Less commonly, returns paid in connection with "Deemed-Debt" and "Deemed-Equity", also do not attract franking credits. However, since the removal of franking these finance structures appear to have become uncommon.

There is little opportunity for a liquidator to "stream" income on liquidation. Streaming (which is possible with trust distributions) is the differential distributions of capital and income, and income from different sources, to different classes of "owner" of the venture. It can enable, for example, distribution of income derived from outside Australia to non-resident owners, who will not be liable to Australian income tax on foreign derived income; whereas franked distributions may be paid to resident taxpayers, reducing the overall tax-burden faced by the owners.

On the other hand, the combined effect of most company constitutions and share issues is that, at least within classes of shares, the returns to shareholders must be the same, and in proportion to the shareholders' entitlements. Attempts to vary the rights of shareholders after allotment of shares to produce differential distributions are apt to fall foul of the General Value Diversion Scheme of the ITAA97 or the general anti-avoidance provisions of Part IVA.

Capital Distributions

Distributions made from paid up capital accounts have no franking credits as they are not derived from income. To the extent that a distribution is made from a "tainted" capital account, that is one which reflects transactions other than the receipt and return of share capital, the distribution may be deemed a dividend in the hands of the recipient who is not entitled to a franking credit.

In the ordinary case, distributions made from sources other than income, which will mean capital gains, will result in CGT event C2. This treats the entire proceeds received as subject to Capital Gains Tax. However, the amount of the gain will be reduced by:

- The acquisition cost of the shares (that is, the cost base);
- The extent that part of the distribution is made from income (that is, is a deemed dividend under s 47)

- The extent that it reflects the sale of goodwill by the company; there is a 50% discount on the capital gain which is allocated to the owners, which is attributable to the shareholders.
- The extent that it includes a distribution of gains from pre-CGT assets, that is those held before 20 September 1985, which are not subject to CGT.

Where shares have been held as capital assets (not trading stock) and held for more than twelve months, holders that are trusts or individuals may be entitled to a discount of 50% on the gain; a superannuation fund is entitled to a 33% discount.

Where the shares were acquired between 20 September 1985 and 21 September 1999, the owner may elect to take either the discount or apply an indexation factor to its cost base when determining the extent of the capital gain. As companies are not entitled to a discount, they will apply the indexation factor where available.

It is worth emphasising that a distribution derived from reserves accumulated from the sale of pre-CGT assets conversely will typically be exempt from CGT or income-tax in the hands of the recipients, provided the shares were held for income-earning purposes and not as trading stock. Preserving and effectively managing the distribution of these “tax exempt” gains remains one of the key parts of voluntary liquidation.

In specie distributions of capital

A company constitution may permit in specie distributions, and must do so if they are to be made. This enables the distribution of different assets or asset classes to individual shareholders, which may have some indirect effects equivalent to streaming, as different rules apply to the valuation and gains recognised on some assets. In general, the market value of the asset distributed will be attributed to the distribution. This may result in a capital gain for the company as there is in effect a deemed sale before the distribution.

Appropriations of Shareholders' funds

A company's shareholders' funds will usually comprise contributed (or paid up) capital; various reserves and one or more retained profits accounts. The separate values of these accounts can exceed that of the net assets available for distribution.

When making a distribution, the liquidator can influence the nature of the receipt in the hands of the shareholder by making the distribution from particular shareholders' funds accounts. A distribution made from a pre-CGT capital profits reserve can have a beneficial tax status: the proceeds may be free of both income and capital gains tax in the hands of the shareholder, depending on when the shares were acquired. In other cases, distributions from capital reserves may attract concessional taxation treatment.

In these cases it is important for the Liquidator to prepare the distribution accounts to show the appropriation carefully, so that there is no accidental combination of the amount distributed. Combination by the liquidator can change the nature of the payment in the hands of the recipient, potentially converting concessional taxed capital distributions into a revenue distribution taxed at the upper marginal income tax rate.

There are opportunities to distribute selectively from shareholders' funds accounts which may result in additional taxation advantages; these are beyond the scope of this paper.

The part of a distribution that is a return of contributed capital (literally the return of capital paid in) will not normally result in a profit or capital gain. However, "return" from a "tainted" share capital account will be treated *pro tanto* as a dividend. "Tainting" refers to transactions on the share capital account *other* than the amount paid in and returns of share capital. A "tainted" distribution is not only income in the hands of the recipient, it is also not able to be franked, so that the tainted income may be subject to double-taxation. For this reason it is important to verify that amounts in the contributed capital accounts have not been tainted.

Completion

Once the net assets are fully distributed, there can be no further distribution to owners, and the liquidator will seek to have the company deregistered. If deregistration occurs within 18 months of the distribution, the distribution will have given rise to CGT event C2 (referred to above): the distribution of capital in connection with the cancellation of shares. However, if deregistration is delayed, or an interim distribution is made, event G2 may be deemed to have occurred. This event has the effect of reducing the cost base of the shares by the extent of the distribution, so that when the final distribution is made the, the effective capital gain is greater. The cumulative effect of events C2 and G2 appears to be equivalent; the chief difference being that a capital loss may be realized under event C2 but not under G2.

Alternatives to liquidation

While liquidation is the traditional means of making distributions, there are alternatives that may have more benign tax effects. Needless to say all of these techniques need to be understood in light of the anti-avoidance provisions of Part IVA. None should be used without the benefit of advice by specialist tax advisors.

- In relation to companies in which there is an active secondary market, which in practice means larger listed companies, the use of share buybacks may reduce or eliminate a taxation liability that would arise from the deeming of distributions as income. This will tend to benefit owners who are:

Natural people (many of whom face margin tax rates below the flat company tax rate);

Trusts (which can distribute gains, but which must derive income to recoup losses);

Other entities with accumulated capital losses for the year.

The most advantageous mechanism is the use of an on-market share buy-back, where the proceeds will be treated as capital unless the shares bought back were held as trading stock or a revenue asset by the vendor-shareholder.

GROUPS

Grouping Principles

Since 2003 the principles governing the taxation position of corporate groups have been considerably simplified by the introduction of "Tax Consolidation". Importantly, the old array of complicated and un-coordinated inter-company relief provisions has been dispensed with. In summary, the current provisions are that:

- Consolidation is available between resident wholly owned entities and their resident parents; in general grouping is not available to non-resident entities;
- Consolidation is optional, but once adopted is irrevocable;
- Consolidation must be of all qualifying entities; including trusts ("one in, all in");
- Consolidation can occur over time;
- Consolidation can only end by one party ceasing to qualify for consolidation. Typically this will involve sale of a subsidiary, but may also result from a change of residence or the issue of minority equity;
- During the life of the consolidated group, all the transactions of other group members are attributed to the "head entity"
- Transactions between group members are ignored for taxation purposes
- Ordinarily the members of the group will execute a Tax Sharing Agreement ("TSA"). In the absence of a TSA, all members of the group are jointly and severally liable for the group's tax obligations
- On entry to the group, the "history" of the entering entity is attributed to the head entity; assets and liabilities are brought to account at market value
- On exit, the "history" of the assets and liabilities that cease to belong to the group at the time of the exit are attributed to the exiting entity. This process involves the calculation of a gain or loss on the entity's acquisition which is attributed to the head entity.
- The exiting company will ordinary leave the group without a taxation liability, and without the benefit of any franking credits relating to past years' earnings.

There is an important qualification to the attribution of "history"; the accumulated tax losses of an entity entering the group are only available to the extent that they would have been available to the entity itself.

Distributions by insolvent entities

As with single entities, the position of insolvent Tax Consolidation Group-members is comparatively straightforward. The company's pre-appointment taxation liability will be determined either on the basis of the Tax Sharing Agreement, or (by default) be borne jointly and severally by the other members of the group. In the latter case, the Commissioner is likely to seek recovery from the solvent entities, who should, in principle, be entitled to contribution as would be the case among co-sureties, although no cases have been decided on the issue.

The ATO considers that an externally administered insolvent company may remain a member of the group; however this view appears to be of little practical significance in the case of an insolvent entity. This view contrasts with the view taken in earlier cases concerning the effect of the change

of control effected by appointment of a liquidator, such as was the case with *Linter* group (which deprived an insolvent company of the benefit of pre-appointment tax losses).

If the company remains a group member, distributions to other members of the group are ignored. They would ordinarily have few taxation consequences in any event. The ATO is presumably entitled to seek recovery of any taxation obligation incurred by the insolvent entity from other group members; however, again the issue appears to be untested.

Distributions by solvent entities

The ATO's view as to the effect of external administration has greater significance in the case of a solvent group member in liquidation. The solvent member will be able to make distributions (whether from capital or income, or whether in discharge of debt or in respect of capital accounts) and discharge liabilities to other group members without any taxation consequence.

Where the member exits the group, it will have attributed to it the cost-base of the assets and liabilities that it takes with it, so as to effect severance from the group.

The process of obtaining tax clearance should, in general, be easier for a member of a consolidated group than an unconsolidated subsidiary.

CONCLUSION

This paper has provided an introduction to what is necessarily a complex and specialised field.

In practice, in all but the most straightforward of distributions, the advice of specialist taxation practitioners must be sought both as a means of avoiding accidental overpayment of taxation and to seek competent advice that the practitioner is not exposed to liability for underpayment or improper avoidance.

Advice will best be obtained after a careful review of the company's trading and taxation history and the identification of issues undertaken using the investigative methods commonly used by insolvency practitioners in other investigations.

Considerable information can be obtained from three sources:

Gates and Sommer, *Tax and Insolvency*, Thomson ATP 2002. Now sadly dated, this is the leading specialist text.

Deutsch et al, *Australian Tax Handbook*, Thomson, annual. A practitioner's handbook which, however, contains much of minor relevance and little on more complicated issues.

ATO – Insolvency Practitioner's page.

ATO – Consolidations Manual