13 December 2024

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Dear Adam

Further Discussion of ATO Director Penalty Notices – Keeping Subbies in jobs and Debt paid

Further to our chats in the past year, we are keen to re-establish our momentum on finding time for us to coordinate and discuss DPN protocols so the ATO gets a better response to debt payment and significantly reduce the need for DPN's.

Below is a briefing on where we let off and detailed solutions. The original briefing note on this was provided some time ago in response to a request from the Assistant Treasurer's office originally.

It is a starting point for a further conversation with you and the Assistant Minister (as necessary). We are keen to collaborate with you to achieve a workable and practical solution that gets everyone to their end goal.

Overview – Recap from previous discussions

- The Development/construction market is very financially unsophisticated, and trades/contractors lack business acumen.
- We, the UDIA projected significant increase in the failure rate of businesses in the Building and Construction industry knowing what was still to come, albeit the data was deficient due to historical lag. The Failure rate occurred as predicted.
- The ATO increased its issuance of DPN's as the ATO cannot afford to allow taxes to go unpaid. Issuing DPN's create problems for the industry and the ATO itself. Unlike an ATO repayment plan the issuing of a DPN or intent-to-disclose notices where the ATO discloses the tax debt to credit bureaus:
  - Causes breach in loan covenants and becomes a default event triggering recall of finance loans.
  - Precipitates of a likely demise as financial organisation recall loans on other project with the same organisation; and
  - Requires the ATO to repay any moneys under the DPN once the organisation is under liquidation /administration (as an unsecured creditor) – ATO does not get significant outstanding moneys.
- The ATO has increased their intent-to-disclose notices where the ATO discloses the tax debt to credit bureaus. This has a similar effect to DPN's and complicates securing new finance and maintaining supplier relationships, especially when both are critical to ensuring the future viability of the organisation.
- The ATO wishes to more effectively manage and communicate to industry for greater response and compliance before DPN's are issued.

- Any affirmative action like DPN's or intent-to-disclose notices that ultimately go on the credit bureaus registers, has a lasting impact on the taxpayer for life, even after exiting bankruptcy or an insolvency event. Financing forms ask " Have you ever been bankrupt, entered into a deed of arrangement, etc?.
- The industry needs retaining of its current skilled workforce/businesses to:

Deliver homes for the current demand where builders and developers can build for profit. The current metrics show a declining capacity to build as the workforce exits due to various factors including insolvency, prices increase resulting in projects being not profitable as the consumer cannot afford to buy.

  - Deliver the Government's affordability and housing supply strategy. Qld's part of the 1.2m housing target 2024-2029 is 245,740 or 49,148 per year. In the past 5 years only 176,531 built, a shortfall of 69,209. (HIA Planning Blueprint Scorecard – August 2024).
  - There is competing interest for the current skilled workforce/ businesses between residential, non-residential and government funded infrastructure projects.
  - We have a supply shortage issue, not a demand shortage issue.

- Any form of insolvency/liquidation/ administration hinders the industries capacity as it reduces available workforce. Some people and businesses will not return.

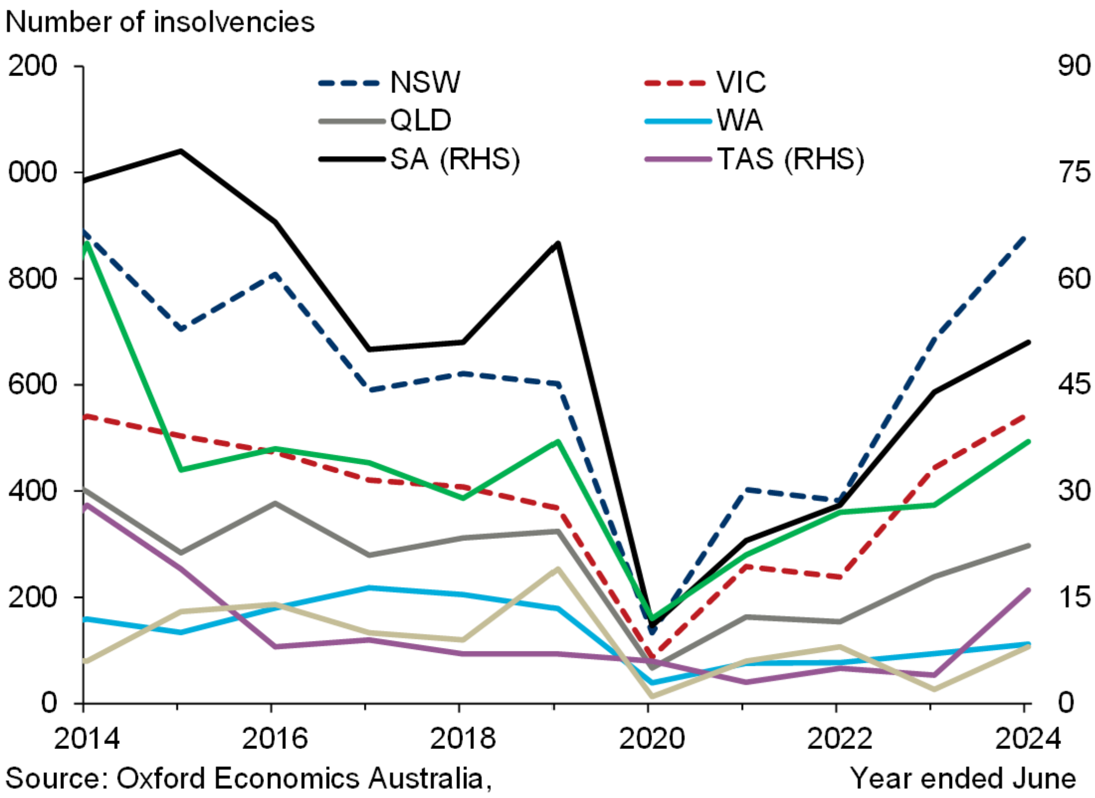
Current Construction Environment

- We understand the ATO is not the problem, but the symptom of industry factors. Businesses tried to stay afloat during the Covid period as businesses were crippled by long term fixed priced contracts in an environment where both supply and labour shortages resulted in unsustainable price increases without the businesses being able to have price increase recoupment. Therefore, businesses used all available working capital and equity. It was also a time when the ATO advised businesses to not worry about the accruing debt and had sympathy to the situation.
- Unfortunately, ATO debt size accelerated due to compounding interest but businesses' working capital had substantially diminished. In the fixed price environment and the build times (i.e. constructing a home takes longer than producing widgets), the lead time to rebuild working capital is quite significant. Under normal trading conditions, a business could work through the ATO debt via cashflow....but these are not normal trading conditions, so the building and construction industry need a different approach to help facilitate them to regain stability and paydown debts.
- It has been reported that the ATO issued 26,702 DPN's worth $4.4bn in the past financial year – a 50% rise from the prior year.
- Some businesses do need liquidation due to poor management, others do not, as the resultant position the business finds is due to circumstances outside their control. Poor management business needs the owners/ leaders education on running a business, and the other's just need some latitude.
- DPN's are causing an increase in corporate insolvency and restructuring matter, but they are also leading to an increase in personal insolvencies of individuals. A DPN notice coupled with

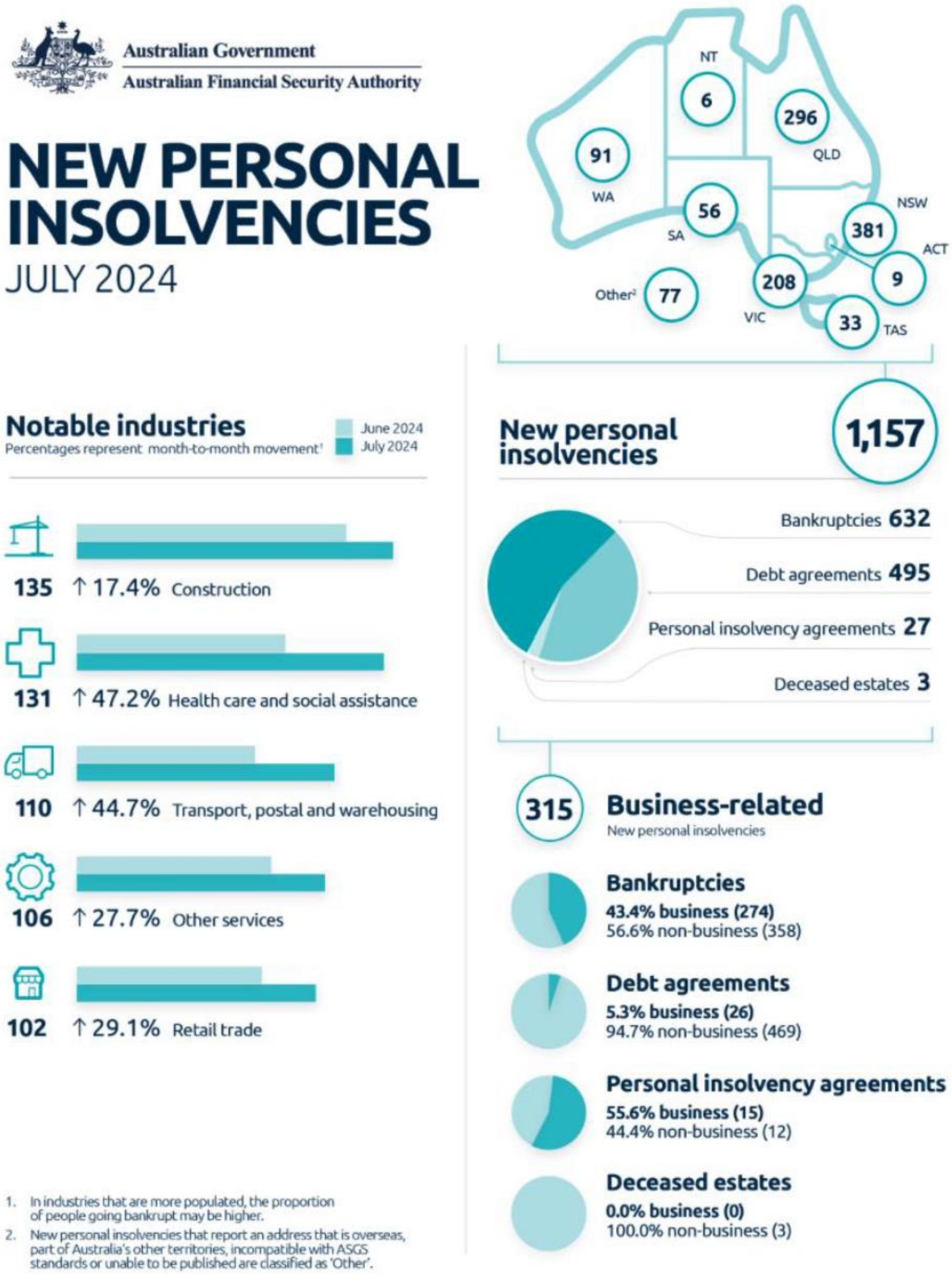
cost-of-living issues and increased expenses like mortgages and rents, food, electricity, individuals are suffering significant financial pressure. In short, the rippling effect of a business becoming insolvent impacts individuals be it the owner, the contractor, the consultant or the subcontractor. These businesses/ individuals do not have the cash buffer zone to withstand large unpaid debts as they did pre-covid. AFSA (Australian Financial Security Authority) data shows that personal insolvencies in the construction sector increased 17.4% to 135 in July 24. Refer below publication.

- The overall industry environment is adverse for construction businesses with NSW and Victoria in particular near insolvency peaks seen in 2014.

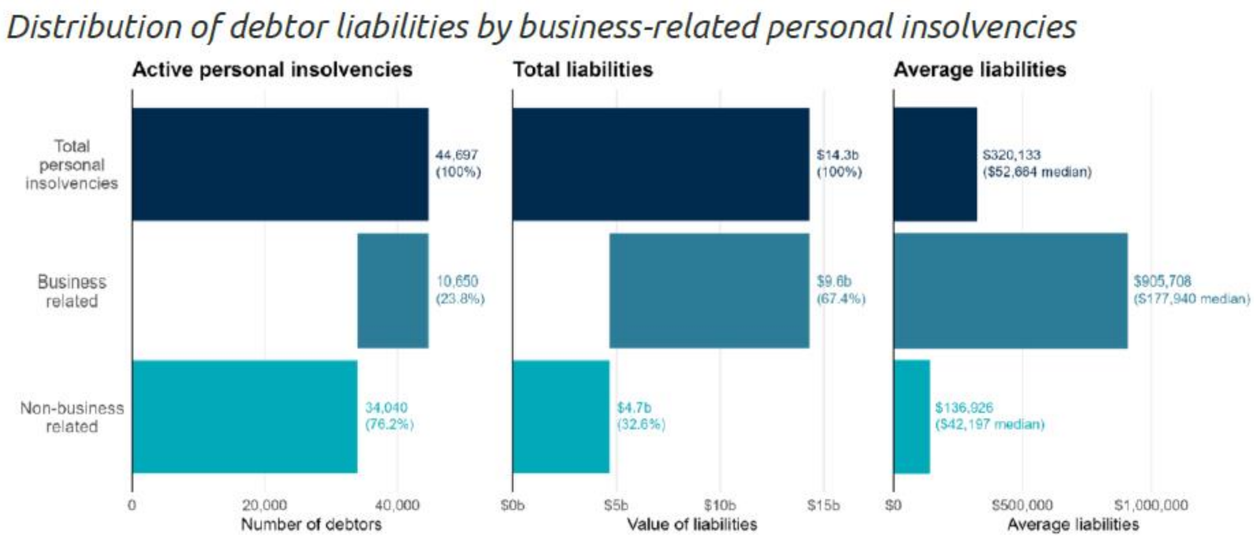
Construction Insolvencies by State



- The Tax office figures on debt show the story for Government receipts.



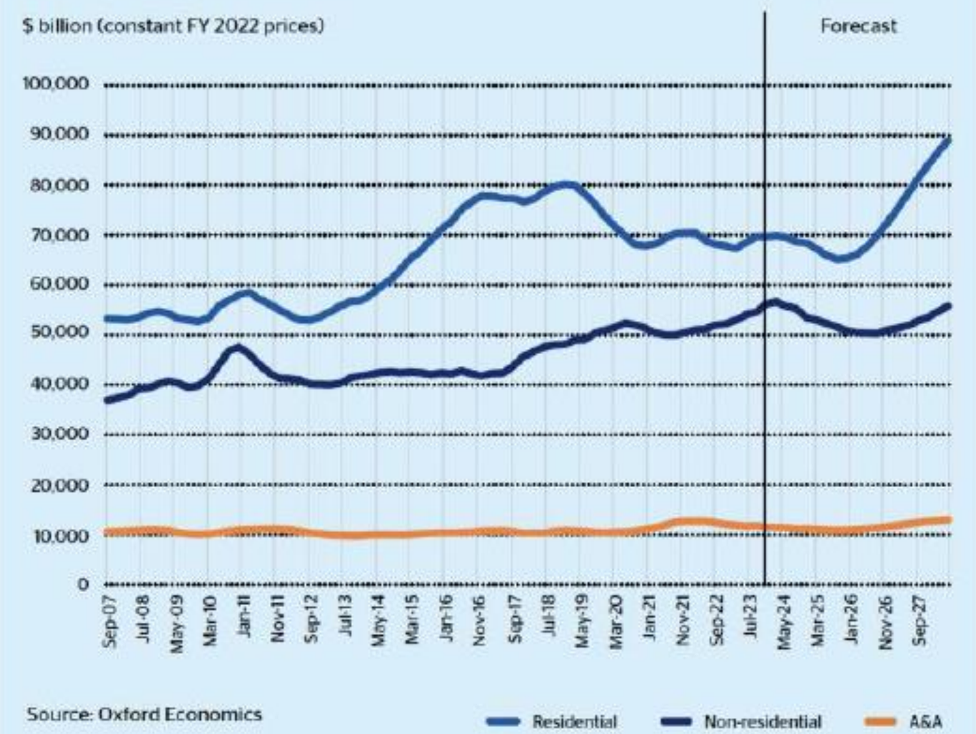
- AFSA continue to show Business-related personal insolvencies include insolvent[?]-definition individuals who have operated as sole traders, in partnerships or were directors in companies. Figure below shows that nearly a quarter (23.8%) of active personal insolvencies are business-related; however, these insolvencies represent a much larger proportion of liabilities.



- In 2023/24 financial year, there were 11,049 insolvencies, a 39% increase from 2022/23 year.
- Credit reporting bureau CreditorWatch reports that thousands of private Australian businesses have failed in the past six months after defaulting on massive tax debts. Some 34 per cent of private businesses with debt to the tax office of more than $100,000 and more than 90 days in arrears – 7003 in total – have become insolvent or voluntarily closed in the last six months.
- Figures from the Australian Securities and Investment Commission show that there have been 1,864 insolvencies in the six weeks to Aug 18, 2024. This represents 45% of the total number of insolvencies that occurred during the total pandemic-stricken 2021 financial year. Please re-read the last sentence…i.e. The number of insolvencies in a 6 weeks period, is greater than the entire 12 month Covid-stricken 2021 year. Expanding the current rate of insolvencies on a linear basis would result in approximately 16,000 insolvencies for the financial year which is unsustainable.
- July 24 saw 45% more insolvencies than in July 2023; 1,238 with the construction industry being the lion share based on industry at 328 appointments or 26%.
- Certainly, the rate of increase has slowed by 11% from a year ago being 48% as the fixed price contract impost start working out of the system. But are there green shoots? Based on the numbers i.e. looking through the rear vision mirror, you would say yes. But, building approvals are the indicator of future work especially in the residential market, and it becomes apparent that future work is tightening. Governments may state the need for affordable housing or consumer demand is high, however profit is the key and overriding determinant what is being built. Building approvals have been on the downhill slide with Jun 24 dropping to the lowest level in 12 years with a 6.5% drop, then only a slight rise again in July24.

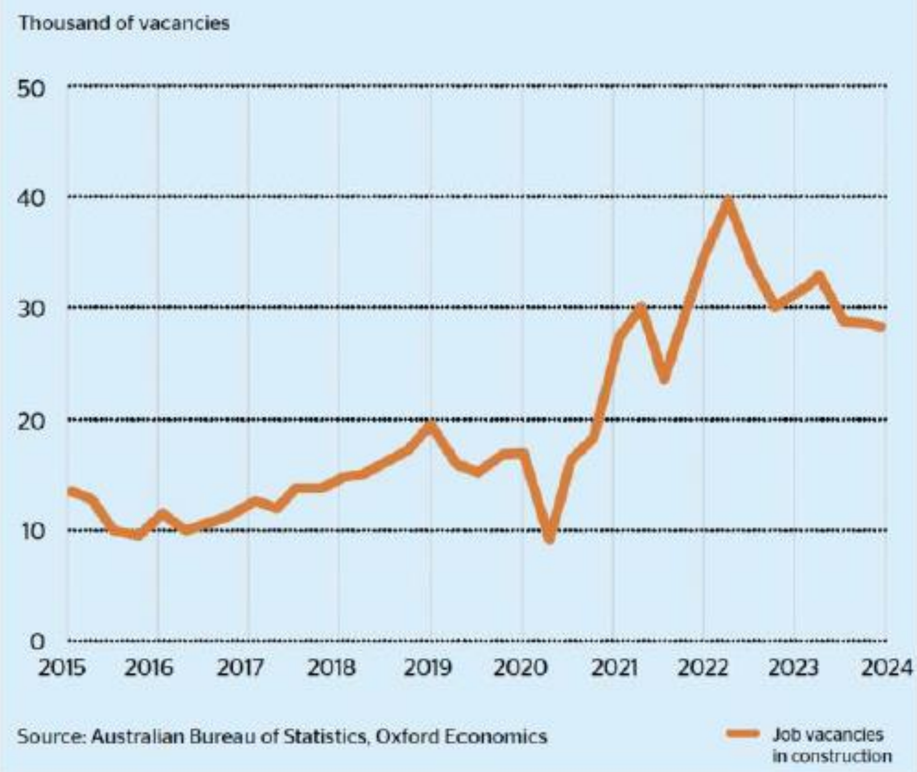
- According to the QBE Australian Construction Sector Outlook report issued July 24, they predict a 5% decline in both residential and non-residential building work for FY2025. They state, it remains stifled by the reluctance of many clients and customers to sign new building contracts as there is a worry about the ability of building and construction companies to meet their obligations amidst uncertainties and tightening of home loan approvals due to the higher interest rates and cost of living. They also state the outlook is influenced by various factors including rising building costs, extended project timelines, their own higher borrowing costs as well as a sticky backlog of fixed-term contracts.
- Public investment activity remains relatively robust which pulls skilled labour from the residential to infrastructure market exacerbating cost pressures and cash flow in the residential sector. There is a requirement to keep current skilled labour within the workforce to help resolve the supply side of the equation and to dampen labour shortage cost growth.

Figure 1: Historical and forecasted building work in Australia by sector[5]



- The scarcity of skilled labour not only affects project timelines but also widens the "green jobs gap" as the industry aims to achieve net-zero targets. Without a significant influx of younger workers coming through the TAFE system or skilled migration, supporting the retainage of the existing workforce and improve productivity is paramount otherwise companies will face challenges in attracting talent and completing projects on time. This puts upward pressure on pricing, cashflow and insolvency. It is estimated, there is approximately 28,000 vacancies within the construction sector.

Figure 4: Job vacancies in the construction sector [11]



Our solution for discussion:

- With a focus on retaining the current building, construction and subcontractor participants to stay in business, we wish to support, foster and educate to improve profitability and mitigate insolvency with a view to help stablise the industry. The ATO is a consequential funder of industry participants due to various economic conditions. We believe the ATO has a role in helping stablise the workforce which will help achieve the delivery of residential and non-residential properties by supporting businesses during these times. Support will ultimately achieve a net gain in tax collections.

Our observations:

- The ATO engagement (through no fault of their own), can be too late or too close to a liquidation event to allow for early interventions to work, and taxpayers often do not engage proactively because they do not understand the implications of the letters. They require an effective ***"Call to Action".***
- Taxpayers do not fully understand that they are personally liable for the GST, PAYG withholding and superannuation and assume that it's only via the issuance of the notice that they become personally liable. All pre – letters received are considered just warnings.
- When a DPN is issued, taxpayers take a while to digest the severity and do not engage positive action for up to 7-10 days of a 21-day notice period, giving little time for the taxpayer and/or the tax professional to attend to the notice.

Our solution in lieu of DPN's:

a) Early engagement and education.

- We suggested a process of (effectively) "Handrails" for taxpayers to ensure compliance is expedited including:
  - Providing ATO warning letters much earlier (say after the second BAS payment being missed as supported by insolvency and restructure representatives). The letter to have an engaging **"Call to action".**
    - Part of the "call to action" is engagement, preferably with or via a tax professional or a member of the restructuring insolvency and turnaround industry with the ATO. The purpose of the engagement is to provide knowledge to the business of the business 'legal obligations, the ATO processes going forward and a discussion around a repayment plan (depending on circumstances).
    - The letter must clarify the pathway that ends with a DPN and making clear the implications of non- engagement.
  - Government funded educational course covering business essentials, focusing on cash, profit and legal obligations, tailored to the Construction industry. A course is developed and is designed to help provide knowledge, not just information.
  - Early engagement and education will only work if there is a willingness on both parties. If a taxpayer endeavours to comply but the ATO becomes heavy handed, then all goodwill is lost.

b) A Repayment plan with no DPN

We suggested a process of (effectively) "Handrails" for taxpayers to ensure compliance is expedited including

- 6 months prior to the issuance of the DPN, "Call to Action" meeting required insisting on a repayment plan. Ideally, the repayment plan can be over 24 months but a plan whereby both parties are acting reasonable. I.e. provides sufficient cash within the business to continue to operate and provide repayments to the ATO. If no repayment plan can be agreed upon, then the matter would escalate to either:
  - a DPN and/or
  - a Small Business Restructure.

- ATO could insist on agreed security over a business asset for tax repayments (pari-pasu with other secured finance). Prior to Covid, the ATO used to see security over personal property. This could be reintroduced.
- If the taxpayer undergoes a Small Business Restructure, then:
  - Available to SME within the construction industry for debts up to $5mil (currently $1mil) inclusive of superannuation. This will capture most of the smaller contractors, subcontractors, consultants and builders.
  - No DPN to be issued whilst repayment progress is made.

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- The ATO right to issue a DPN is never extinguished but asking the ATO to provide an extended time for repayment. There may be lenience on penalties as part of the repayment negotiations.

A small Business restructure as a viable alternative to liquidation should avoid the rippling effect of business insolvency, personally insolvency and keep the skilled workforce and business active. More importantly, early engagement and education should always be the focus as it benefits all stakeholders.

We are keen to set up a time in the new year to workshop through the options with you. Please let us know what time may be suitable after 15 January.

Please do not hesitate to contact the UDIA National Head of Policy and Government Relations - Andrew Mihno on 0406 454 549 to discuss this further.

Yours sincerely

Col Dutton
UDIA National President