



THOMSON REUTERS

WEEKLY TAX BULLETIN

www.thomsonreuters.com.au/tax



THOMSON REUTERS WEEKLY TAX BULLETIN

Issue 15, 15 APRIL 2011

[522] Federal codification of personal property securities law will affect *Phillips* Trusts and asset protection structures

- by *Oliver Shtein, Executive Lawyer, Bartier Perry Pty Limited*

In 2009, the Federal Government enacted the *Personal Property Securities Act 2009* ("**PPSA**"). Despite being amended twice already (with a third amending Bill now before Parliament), PPSA has remained essentially dormant while the Government prepares the new Personal Property Securities Register ("**PPSR**") and industry readies itself for the profound changes the new law will bring. A new start date in October 2011 has been announced. The exact date in October is yet to be set.

So why should PPSA be of interest (and concern) to tax practitioners and their clients? Well, while representing a major change in its own right, these new laws also affect service trust and asset protection structures (as I explain below).

But first, some brief but necessary background.

Major reform to the law of personal property

PPSA is a major legislative change with over 70 Federal and State Acts either repealed or amended. Virtually all State and Federal registers of security interests (eg REVS, ASIC charges, security interest in goods registers) are being abolished and replaced by the PPSR. Data from existing registers is being 'migrated' to the PPSR.

The Act endeavours to create a code for the creation, priority and enforcement of personal property securities. It brings significant changes to the law of personal property, essentially covering everything except land and water rights.

PPSA reaches far beyond "securities" as that term is typically understood in a finance context. Instead, it applies a wide and "functional" definition of a security interest.

As well as applying to mortgages and charges, PPSA will also apply to:

- certain long-term or indefinite leases and bailments for value. These are to be designated as "PPS leases". PPS leases will include simple hires as well as finance-type leases. For motor vehicles, watercraft and aircraft, the minimum time threshold for there to be a PPS lease is 90 days. For other assets, it is one year. However, leases for an indefinite term are also caught and option periods and consensual holding over periods are taken into account in determining whether the time thresholds are breached.
- Retention of title sales.
- Floor plan arrangements and "commercial consignments".

These will all be deemed "security interests" under PPSA.

A central policy objective of PPSA is to require owners, or those having security over personal property, to make their rights or ownership public where, otherwise, those extending credit to the apparent owner might be misled about its asset position. This policy is already evident in the requirement for registration of typical mortgage and charge security, but it is being extended greatly to those deemed security interests mentioned above which in legal terms consist of ownership interests eg the owner of leased equipment.

PPSA and service trusts

PPSA is an extremely complex and far-reaching piece of legislation and a full discussion of it is well beyond the scope of this article. Attention is drawn here in particular only to the effect of PPSA on asset hire agreements that are normally part of typical "Phillips Trust" or service company structures.

The Phillips case

As recounted by the Commissioner of Taxation in Taxation Ruling TR 2006/2, the decision in *FCT v Phillips* (1978) 8 ATR 783 concerned a partner in a national firm of accountants. The firm set up a unit trust to provide furniture, equipment and non-professional services to the partnership. Units in the trust were, with one exception, held by the partners' family members, family companies or trusts. The service arrangement would relieve the firm from most problems of staff and office management.

A central reason given by the firm for establishing the arrangement was to diminish the assets held beneficially by the firm and its individual partners and to increase the assets held for the benefit of their families, placing them outside the possibilities of loss to litigation-minded clients and third parties.

That strategy relied on the simple proposition that, were the partnership to fail due to a professional negligence claim, as the owner of the assets, the Phillips Trust would be able to retrieve them, without further ado, from the unsecured creditors of the partnership.

PPSA changes that.

Effect of PPSA on *Phillips* trusts

As noted above, a radical aspect of the PPSA is that ownership of an asset can be a deemed "security interest". Hence an owner of an asset subject to a "PPS lease" will be regarded as having a security interest in that asset. The lessee or bailee will be deemed to be a "grantor" of that interest to the owner. By a statutory fiction, the

legislation deems the grantor to have rights in the asset (called the "collateral" under PPSA) that it can grant to the owner.

In a further radical change, PPSA may operate to deprive or impair ownership rights if the security interest in the collateral is not "perfected". For PPS leases, this will normally require registration of the interest on the PPSR.

PPSA contains a number of rules that punish an owner for failure to "perfect" and which may negate asset protection strategies along the lines of *Phillips*.

Unperfected security interests lose priority

Under s 55(3) of PPSA, a perfected security interest has priority over an unperfected security interest in the same collateral. The operation of this kind of rule is well illustrated by a New Zealand decision. (The PPSA is closely modelled on the New Zealand legislation.)

In *Waller v New Zealand Bloodstock Limited* [2006] 3 NZLR 629, Glenmorgan Farm had given security over "all its present and future assets" to Lock, a financier. Glenmorgan entered into a lease to purchase agreement for a thoroughbred racehorse, "*Generous*" with New Zealand Bloodstock. Lock perfected its security interest by registering a financing statement on the PPS register.

Glenmorgan defaulted under the lease agreement with NZ Bloodstock and the lease was terminated. NZ Bloodstock repossessed *Generous*, however, Lock claimed that it was entitled to *Generous*.

The New Zealand High Court found that:

- relying on the particular statutory wording and a broad reading of the expression "assets", Lock's security interest encompassed Glenmorgan's interest in *Generous*.
- NZ Bloodstock had a security interest in the lease under the general provisions of the NZ legislation, but because this was not perfected Lock's security interest had priority.

Allan J referred to the Canadian Supreme Court (Canada also has a PPSA-style regime) decision in *Re Griffin* [1998]:

"A person with an interest rooted in title to property in the possession of another, once perfected, can, in the event of default by the debtor, look to the property ahead of all others to satisfy his claim. However, if that interest is not perfected, it is vulnerable, even though it is rooted in title to the goods."

The case was not therefore determined on traditional concepts of title and ownership but by applying the PPSA-type legislative priority rules. Lock's security over Glenmorgan gave it a priority claim to the horse even though the horse was at no point owned by Glenmorgan.

Unperfected interests "vest in the grantor" on insolvency

Under s 267 of PPSA, if a security interest has not been perfected, it "vests in the grantor" in the grantor's insolvency. As the security interest may be regarded as the interest of a lessor or bailor under a PPS lease, the section appears to mean that upon a company entering into administration, winding-up or a deed of company

arrangement, there is effected a kind of statutory expropriation with the property in the asset transferring from the lessor or bailor to the grantor (the lessee or bailee under the PPS lease).

The Act will therefore modify or abolish a number of legal rules, not least of which is the *nemo dat quod non habet* rule [in essence, that the purchase of a possession from someone who has no ownership right to it also denies the purchaser any ownership title], which is substantially undermined. Under another rule, a buyer or lessee of collateral that is subject to an unperfected security interest will take free of that interest.

Example

The following example illustrates how PPSA could work to undo a *Phillips*-type strategy.

Imperfect Partners Pty Limited operates a taxation advisory practice. Its directors have decided that assets such as office furniture and the firm's impressive collection of Renaissance paintings (which adorn the walls of Imperfect Partners offices) should be held in *Phillips*-style unit trust (the Safety First Trust) with a trustee company - Safety First Pty Limited.

The unit holders of the Safety First Trust are trustees of discretionary family trusts associated with the principals of Imperfect Partners.

Tax advice is provided to clients by Imperfect Partners Pty Limited which pays service fees to Safety First as part of the asset protection and income-splitting strategy in accordance with the Tax Commissioner's "safe harbour" rules.

There is a service agreement between Imperfect Partners and Safety First which sets out the fees and provides that either side can terminate on a month's notice.

Imperfect Partners suffers a catastrophic claim for professional negligence and appoints a voluntary administrator.

Safety First has not been told about PPSA and is unaware that the arrangements for use of the assets by Imperfect Partners amount to a PPS lease which is a "security interest". Accordingly, there is no registration of the arrangement on the PPSR.

Outcome

The personal property owned by Safety First "vests in the grantor" Imperfect Partners, and is sold by its administrator to pay the damages claim.

It doesn't matter that the assets are owned by Safety First.

***Phillips*-type structures need review**

We suggest that *Phillips*-type structures will need review to ensure they are perfected. PPSA also sets out formal requirements for the enforceability of security interests and these will need to be considered as a part of implementation or maintenance of these structures. The timing of registration relative to the delivery of possession of assets is also critical for priority reasons.

There is limited transitional protection for 2 years after PPSA takes effect but the transitional scheme is complex.

Beyond the professional services sector and *Phillips*-type arrangements, PPSA has implications for asset protection structures within corporate groups and in particular the use of special purpose subsidiaries for risky enterprises.
