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Tax Alert

Property sales: How a mortgagee can be left with nothing

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Where a property that is subject to a mortgage is sold, the Commissioner of Taxation may step in and effectively redirect the purchase money away from the vendor and / or mortgagee. That money instead goes directly to the ATO, to satisfy a tax debt owed by the vendor. This has the effect of cutting out a mortgagee's right to have their loan repaid.

In the recent decision of *Commissioner of Taxation v Park* [2012] FCAFC 122, the Full Federal Court held that where a third party (which may include a purchaser) is given a garnishee notice by the Commissioner, the purchaser must comply with the requirements of that notice, notwithstanding the existence of a registered mortgage on title. Once the notice is given, the purchaser is taken to owe the amounts to the Commissioner. As occurred in *Park*, this could leave the mortgagee with no way to recover money owed to them.

The result is that mortgagees who hold registered mortgages over property to secure their debt can no longer be sure of receiving any money if they discharge their mortgage during settlement. In *Park*, a mortgagee who released their security over the property, to allow settlement to take place, did not receive their debt repaid in full. The purchaser, rather than giving the money to the vendor, was obliged to pay that money to the Commissioner instead. In fact, if the purchaser had failed to comply with that notice, the tax law says that is a criminal offence.

Garnishee notices: how do they work?

Where a taxpayer (referred to as a '**debtor**') owes a debt to the ATO, and a third party owes (or may later owe) money to the debtor, the Commissioner may issue a written notice to recover that debt from the third party.

The third party cannot be made to pay the Commissioner more than they owe to the debtor. The notice may also provide for payment where there will be amounts of available money from time to time. This effectively means that the third party's obligation may be ongoing, depending on the terms of their obligation to the debtor.

If the third party fails to comply with the notice, it is a criminal offence currently punishable by up to $2,200. This penalty may be in addition to the amount payable to the Commissioner under the notice.

Park's case

A vendor entered into a contract for the sale of property with settlement due in 30 days. At the time of entering the contract, the property was subject to 2 mortgages. The purchase price was not enough to cover the outstanding loan amounts.

The vendor also owed a substantial amount of unpaid tax and interest. The Commissioner gave a notice to the purchaser in respect of this debt.

Settlement was delayed because of the notice. The sticking point was payment of the unpaid taxes. The Commissioner refused to withdraw the notice and the second mortgagee refused to provide a release of its mortgage.

Settlement eventually occurred and the dispute of the unpaid taxes was decided by the courts. Ultimately, the Full Federal Court found that:

- The Commissioner was entitled to the whole of the unpaid taxes in priority to the mortgagee.
- There were no amounts 'owing' under the contract until settlement took place, so the notice had no effect until that time.
- Regardless of any arrangements for distributing the funds at settlement, there could never be a situation where the purchasers owed anything to the mortgagee. That means that the mortgagee could not have a beneficial interest in the purchase monies. The Commissioner's notice would only be subject to the mortgagee's interest if the mortgagee, and not the vendor, had a beneficial interest in the purchase monies. As this was not the case, the notice was still enforceable.

The effect of the Court's decision is that:

- The Commissioner is not required to consider the rights of a mortgagee in enforcing a debt under a notice;
- Enforcing the payment of taxes owed does not convert an unwilling mortgagee into an unsecured creditor; and
- A debt owed to a mortgagee is only compromised when a mortgagee releases its security over property. Until that point, the purchaser has no obligation to pay the Commissioner under a notice.

A Brave New World?

In *Park*, the mortgagee released its security over the property, in order to get a share of the settlement proceeds. If it had not done so, settlement would not have been effected, and no purchase monies would be available.

However, once the bank agreed to release its security, settlement could occur and the purchase monies could be made available, and as a consequence, the Commissioner's rights under the notice are enlivened, and take priority to the purchase monies available.

Either way, the mortgagee receives nothing, and the purchaser takes good title.

This case serves as a warning to any mortgagee providing a release of security at settlement. There is no ability for a creditor to check to see if their debtor owes money to the ATO, without the debtor's express consent. Accordingly, unless a mortgagee is notified before settlement of a garnishee notice served on a purchaser, they remain unaware that the moment they hand over the release of their security is the moment that their position becomes compromised. At that point, they are in effect enlivening an obligation under a notice to pay the vendor's unpaid taxes.

In response to *Park*, mortgagees might be tempted to keep their registered mortgages on foot, to ensure that their interests remain secured. This may result in delayed or unsuccessful settlements, or even expose mortgagees to claims by unsatisfied mortgagors when the sale of property is delayed or contracts rescinded as a result of a mortgagee's refusal to discharge their mortgage.

Alternatively, mortgagees may seek alternative temporary security from a vendor, or even seek the vendor's permission to make enquiries of the Commissioner to determine if the vendor owes unpaid taxes before releasing a security.

The Court's decision cannot be ignored. It leaves mortgagees in an uncertain position with a risky outlook which increases uncertainty and costs. Any person acting on a behalf a vendor, mortgagee or purchaser in such circumstances is strongly advised to obtain specialist legal advice.

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