

## **Chapter 15**

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### **Managing Related Tax Cases**



## Managing Related Tax Cases

15.1 Effective debt collection involves the coordinated pursuit of the tax liabilities of related entities in order to combat

- the emergence of unsustainable tax liabilities without the prospect of recovery
- tax abuse associated with the Phoenix Syndrome<sup>129</sup>
- any failure to pay over fiduciary taxes<sup>130</sup>.

## Commonality Checking

15.2 A risk to debt collection arises where businesses are linked through principals who

- have involvement with other existing businesses that have significant tax debts or non-compliance or
- have links to a failed business where the protection of limited liability might have been deliberately used to evade the payment of fiduciary taxes.

15.3 To address this risk, the Revenue Commissioners engage in a process of commonality checking in order to identify entities with common directors or participants and where appropriate

- manage the collective debt as well as pursuing each individual taxpayer
- identify businesses that have relationships with failed businesses<sup>131</sup> in order to identify cases for close monitoring and more active pursuit of debts.

15.4 In order to identify related entities Revenue searches for businesses with common principals using information held on its own systems as well as by the Companies Registration Office<sup>132</sup>. The checks (which Revenue treat as mandatory) are conducted by Revenue's debt management and new tax registration units. Commonality checks are conducted in the case of all new registrations for tax and in instances where the declared (or estimated) tax arrears or tax liability exceeds €50,000, or where a write-off of tax in excess of €50,000 is being proposed.

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<sup>129</sup> See Annex A.

<sup>130</sup> The fiduciary taxes are VAT, PAYE/PRSI and Relevant Contracts Tax and are collected by businesses on behalf of Revenue and held in trust until paid to Revenue.

<sup>131</sup> These include, businesses with the same address as the failed entity or operating in the same locality, operating the same business as the failed entity or within the same field, having a director that is common to both the new business and the failed entity or instances where there is either family or employer links between the directors in the new and failed entity.

<sup>132</sup> Information held by the Companies Registration Office allows Revenue to identify other companies with which individuals are or were a director.

## Pursuit of Debt in Commonality Cases

15.5 Where relationships with other entities are established and a heightened compliance risk exists, either due to a significant combined debt or the existence of a connection with a previous failed business, further debt management is conducted by a Dedicated Pursuit Unit located in the Collector General's Office. The Dedicated Pursuit Unit has two sub-units

- a Commonality Unit responsible for managing the debt and compliance of cases related through common directors where the total debt exceeds €250,000
- a Phoenix Unit responsible for managing the debt and compliance of cases related to a failed entity.

15.6 The Commonality Unit manages groups of cases with debts in excess of €250,000. The objective is to make a timely debt collection impact through the use of appropriate enforcement measures. Where a business and its related entities remains compliant for a period of two years the group of businesses is removed from management by the Commonality or Phoenix Units. In 2010, there were 24 cases removed from the Commonality Unit and 42 cases removed from the Phoenix Unit.

15.7 The aim of the Phoenix Unit is to combat the emergence of what is called the Phoenix Syndrome – the characteristics of which are set out at Annex A. Key functions of the Phoenix Unit are to establish the circumstances of the prior business failure and where it is established that it is not genuine<sup>133</sup> ensure that the new entity makes its returns and payments on time and manage any tax arrears which may have built up prior to the case being referred.

15.8 Collection enforcement carried out by both the Commonality and Phoenix Units accounted for 3% of Revenue's total collection enforcements in 2010 and

- The Commonality Unit had 3,637 cases on hand at the end of 2010. 2,466 (68%) of those cases were compliant. A case is deemed compliant where the outstanding liability is nil. While cases are managed in the Unit by cluster no information was available on cluster compliance.
- The Phoenix Unit had 675 cases on hand at the end of 2010 and 395 (59%) of those cases were substantially compliant. Substantial compliance, in this instance, is where the liability in the case is less than €5,000.

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<sup>133</sup> Revenue guidelines on the "Identification of Phoenix Cases" provide that genuine business failure is not a reason to monitor a case as "phoenix".

## Chapter Focus

The effectiveness of the commonality checking process depends on the accurate identification of all relevant cases and their referral as appropriate for enhanced debt management.

The audit set out to examine

- whether commonality checks are carried out in appropriate cases and the results recorded
- in respect of cases checked, the accuracy of those checks in identifying all relevant relationships
- whether appropriate cases are being referred to the Dedicated Pursuit Unit and the relevant debt management unit.

## Conduct of Commonality Check

15.9 Where commonality checking detects a common link between the principals in businesses, the details of each relationship should be noted on Revenue's Common Registration System (CRS). The recording is a two stage process

- a marker is placed on the individual case to show that a commonality check has been conducted
- the actual relationships identified are noted in a relationship and/or customer notes section in each individual case.

15.10 A sample of cases meeting the criteria for a commonality check was examined in the course of audit. Cases were selected at random from VAT registrations, arrears greater than €50,000 and cases considered for write-off greater than €50,000 in 2010. The focus of the review was on determining whether the checks had been conducted and whether the results had been accurately recorded on CRS. A sample of 110 cases was examined. There was no evidence that the required commonality checks had been conducted in 18% of cases. The results are set out in Figure 78.

**Figure 78 Commonality Checks**

	Number	Proportion
Check completed and results recorded on CRS <sup>a</sup>	90	82%
No evidence that a check was conducted	20	18%
<b>Total cases sampled</b>	<b>110</b>	<b>100%</b>

Note: a The audit treated the check as recorded if a commonality marker was inserted or the computerised case notes recorded evidence of the check. In 75 cases, a commonality marker was present on the case. A further 15 cases were identified where the case notes showed evidence that a commonality check had been conducted. In five of those cases the check was completed six months after the date required.

15.11 A review conducted by Revenue of the Commonality Programme in September 2009 also raised concerns in relation to the absence of commonality checks in some cases. In relation to checks by debt management units, the review concluded that commonality checks were not always conducted where warranted and as a result, cases were not being referred for pursuit at the earliest juncture. The Revenue review found that 47% of the clusters being managed, at that time, in the Commonality Unit had debts in excess of €500,000 by the time the case was referred.

15.12 The same review of the Commonality Programme also noted that Revenue's Central Write-Off Unit reviews the conduct and recording of commonality checks in a sample of write-off cases being submitted to the Chairman for formal sign-off. The review noted that the exercise conducted by the Central Write-Off Unit also identifies cases where there is no record of the commonality check having been performed<sup>134</sup>.

15.13 Internal Audit examines all write-off cases and its reviews identify shortcomings in the conduct of commonality checks in cases where tax debts in excess of €50,000 are being written off. Matters identified included cases where

- the commonality check was not completed or recorded in the proper location on Revenue's systems
- the check was conducted even though the debts were less than €50,000 and
- debts in excess of €250,000 were not referred to the Commonality Unit.

15.14 The 2010 review of write-off cases conducted by Internal Audit found that commonality checks were properly recorded in 57% of cases.

### **Accuracy of Recorded Checks**

15.15 Where Revenue had conducted a commonality check, the audit reviewed the results of those checks with a view to establishing whether all of the relationships with other entities were properly identified and recorded in CRS. In order to do this, the commonality check was reperformed by reference to data held by the Companies Registration Office and on Revenue's systems.

15.16 Three cases in the sample were excluded on the basis that the cases are currently monitored by the Large Cases Division<sup>135</sup>. In the remaining 87 cases, the audit concluded that no relationships existed in 45 of the cases while in 42 of the cases examined relationships existed.

15.17 In those cases where relationships were identified during the audit the Revenue commonality check conducted had

- accurately concluded on the relationships in 21 cases
- identified some of the relationships in 8 cases
- identified none of the relationships in 13 cases.

15.18 The audit concluded that Revenue had not identified relevant relationships in 15% of cases with identified commonality features and had done so incompletely in a further 9% of cases.

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<sup>134</sup> There are no records maintained of the extent of this but Revenue staff stated that in up to 50% of write-off cases examined a commonality check had not been completed.

<sup>135</sup> In excess of 100 relationships were identified in each of these cases.

## Referral of Cases

15.19 The identification of commonality features may call for referral to special units charged with debt pursuit.

15.20 Where commonality links are established, the extent of the debt of the related cases is examined by reviewing the compliance record<sup>136</sup> on Revenue's Integrated Taxation Processing system.

15.21 In instances where the case that triggered the commonality check is a new registration the process is as follows

- where the case is related to a business that ceased or abandoned trade with significant tax debts i.e. debt greater than €50,000 and meets a number of criteria related to phoenix companies, the case is referred to the Phoenix Unit
- where relationships are found and there are no links to a failed entity the case is allocated to the appropriate debt management unit.

15.22 In cases, other than new registrations

- Where the combined debt is greater than €250,000, the related cases are referred as a group to the Commonality Unit<sup>137</sup>.
- Where the combined debt is between €50,000 and €250,000, the case worker responsible for the case with the highest debt becomes a liaison officer for all of the related cases. This officer is responsible for agreeing a strategy for collecting the outstanding debt and monitoring the related cases with the other caseworkers.
- Where the combined debt is less than €50,000, there are no changes to the debt management process i.e. the case continues to be debt managed in the relevant debt management unit as normal.

15.23 In order to function effectively the units charged with follow up would need to have all relevant cases referred to them and a process to ensure that non-relevant cases were excluded or filtered.

15.24 Of the 110 cases examined, 8 were appropriate for referral to the Dedicated Pursuit Unit since they had links to a failed entity (one case) and, in the remainder, had debt above the relevant threshold for referral at April 2011<sup>138</sup>. Figure 79 sets out the extent to which the cases were referred.

<sup>136</sup> In reviewing the compliance record of an entity a caseworker checks for any returns outstanding, unpaid tax or previous tax written off.

<sup>137</sup> One exception to this is in cases where the appropriate decision is to liquidate the company. The debt management unit continues with the action and the remaining cases are referred to the Commonality Unit.

<sup>138</sup> The combined debts were assessed in each case at April 2011 based on information from Revenue's Integrated Taxation Processing system. Cases were then compared to the list of cases on hand in the enforcement units for the same period to determine whether the case had been referred.

**Figure 79 Referral of Commonality Cases to Dedicated Pursuit Unit**

Feature	Unit	Suitable for referral to Pursuit Unit <sup>a</sup>	Referred cases	Not referred
Related to failed entity with debt > €50,000	Phoenix Unit	1	1	-
Combined debt of entity > €250,000	Commonality Unit	7 <sup>a</sup>	5	2
<b>Total</b>		<b>8</b>	<b>6</b>	<b>2</b>

Note: a Two further cases were identified that exceeded the debt thresholds and on further investigation there was only one entity suitable for referral as the remaining related entities were in liquidation.

15.25 Effective pursuit of cases is dependent upon the extent to which Revenue has identified all of the relevant relationships. While, on one hand, one quarter of appropriate cases were not referred for pursuit, on the other hand, it appears that inappropriate cases were, at the same time, being referred. Both the Commonality Unit and the Phoenix Unit conducted reviews of the suitability of cases referred to them in 2010. Figure 80 sets out the number of clusters referred to both units during 2010 and the proportion deemed suitable.

**Figure 80 Groups Referred to Commonality Unit 2010**

Unit	Total referrals	Suitable referrals	Not suitable referrals
Commonality Unit	462	279	183
Phoenix Unit	406	209	197
<b>Total</b>	<b>868</b>	<b>488</b>	<b>380</b>

Source: Commonality Unit, Collector General's Office

15.26 Overall, just over half of the cases referred were suitable for further pursuit. The reasons cases were deemed unsuitable in the case of the Phoenix Unit have only been recorded from June 2010 onwards and they show that just under half of the cases were not in fact phoenix cases and over one third of cases were below the debt threshold. In addition, 87% of the unsuitable cases received by the Commonality Unit were also found to be below the debt threshold. This has implications for the effectiveness of the referral process.

15.27 In instances where the case that triggers the commonality check is in liquidation, connected cases should be referred for pursuit since risk features are associated with the combined group debt. Revenue guidelines on commonality checks provide that 'where a case is being managed by a debt management unit and the only appropriate decision in the case is to liquidate the company by issuing a letter under Section 214 of the Companies Act 1963, that unit should continue with the action in the case and refer, where appropriate, all other cases in the cluster to the Commonality Units.'

15.28 Revenue's guidelines specify that referrals must contain at least two businesses or partnerships currently registered for tax. The result is that in cases where one entity in a group continues to trade and the related entities are in liquidation, the case is not referred to the Commonality Unit.

## Administrative Matters

15.29 In 2010, Revenue reviewed the effectiveness of the commonality check in identifying the emergence of phoenix companies and it concluded that there is an increase in cases in the Phoenix Unit due to the economic downturn. The review also drew attention to the fact that the commonality check as currently conducted does not identify a phoenix company where the director of the failed entity acts as a shadow director in a newly formed phoenix entity.

15.30 It recommended that the Phoenix Unit should work proactively with Revenue Districts and agencies who share information with Revenue to identify possible phoenix cases where shadow directors are operating.

## Management Information

15.31 In regard to the administration of the Commonality Programme the audit noted that the management information systems appeared to be deficient in that

- the Dedicated Pursuit Unit does not currently have a list of phoenix cases on hand – this militates against controlled management of this category of cases
- a fully accurate figure on the debt outstanding in commonality and phoenix cases could not be supplied due to discrepancies in information held on cases by the Unit.

15.32 In response to my inquiries in this regard, the Accounting Officer stated that there are robust management controls and evaluation systems in place within the Phoenix and Commonality Units. Revenue has scheduled an IT development to place a marker on cases to identify them as being managed in the Dedicated Pursuit Unit. The absence of this marker means that the process of producing lists of cases and associated debt is a manual and labour intensive process.

## Views of the Accounting Officer

15.33 The Accounting Officer accepted that challenges arise with systems wholly reliant on checks being undertaken manually. She drew attention to an initiative introduced as part of a move to electronic registration for customers. Revenue has introduced an automated commonality check (auto-commonality) in 2011 which is conducted on all new VAT and Relevant Contracts Tax registrations before the registration is approved. Auto commonality will in time apply to all new tax registrations.

15.34 She stated that Revenue has also undertaken a series of training workshops for staff on how and when to complete the commonality check. In 2011, 270 Revenue staff attended these workshops.

15.35 In relation to instances where appropriate cases are not referred, the Accounting Officer stated that while Revenue has taken and will continue to take all reasonable steps to ensure optimal operation of the programme through the full operation of the commonality checks (as evidenced by the training workshops and the introduction of auto-commonality checking), nevertheless she was satisfied that the working of the cases in the debt management units even where commonality issues are not fully identified in accordance with Revenue guidelines is giving effective management of cases with significant compliance and/or debt issues.

15.36 She noted that while there are some deficiencies and ongoing efforts are being applied to overcome them, issues of real substance in terms of tax foregone do not arise from those deficiencies. Where Revenue had not identified all relevant relationships or where no relationships were identified, the follow up review conducted by Revenue of the cases concerned shows that the normal debt management case working had ensured that the tax debts had been fully controlled.

15.37 The Accounting Officer stated that the large number of cases referred to the Commonality Unit below the debt threshold arose due to challenges for registration units in identifying the lead debt management unit. As a result, a practice developed whereby cases between €50,000 and €250,000 were referred to the Commonality Unit which then distributed the cases to the relevant debt management unit. This practice was formalised in 2011.

15.38 The Accounting Officer considers that the build up of debts in excess of €500,000 before referral does not necessarily reflect a failing of the conduct of commonality checks. It can occur where

- connected entities submit several overdue returns without payments to Revenue at the same time
- where a case is already undergoing active enforcement by a debt management unit and is not, therefore, the subject of immediate referral to the Dedicated Pursuit Unit until that enforcement has been concluded.

## Conclusion

Revenue's commonality approach is a useful way of addressing debt collection with specific risk features that attach to related entities. However, its effectiveness depends on completeness in the performance of checks, recording related parties identified in the course of that checking and referring appropriate cases for pursuit. The audit found that

- there was no evidence of checks in 18% of cases where they should have been conducted
- where they were conducted, relevant relationships were not identified in 15% of cases and incompletely identified in a further 9% of cases
- some cases appropriate for referral to the Dedicated Pursuit Unit were not referred.

The efficiency and effectiveness of commonality checking and follow up is hampered by deficiencies in case recording and the referral of unsuitable cases to pursuit units.

In cases where relationships are identified with companies in liquidation, the debts of the trading entity are not referred to the Commonality Unit for monitoring. In light of the increased risk of non-collection of debts, in such instances, there may be merit in referral of those cases to the Commonality Unit.

## **Annex A Characteristics of Phoenix Companies**

In 2004, the International Association of Insolvency Regulators<sup>139</sup> published a survey - “The Regulation of Phoenix Companies”. The survey was completed by 13 members and set out their experience in dealing with the Phoenix Syndrome. The report outlined the typical characteristics of phoenix companies and specific characteristics with respect to companies in Ireland.

### **Phoenix Characteristics identified by the Survey**

#### ***Failed Entity***

- Undercapitalised normally having a minimum share capital.
- Insolvent.
- Depletion of assets shortly before cessation.
- Operated to evade some or all of its prior liabilities.

#### ***Phoenix Company (General)***

- Formed with nominal share capital.
- Operates in the same or related business area.
- Commences operation immediately prior to cessation of the trade of the failed entity or within a short period (no more than 12 months).
- Directors/Managers/Controllers also operated the previous business.
- Employees of the former business proceed to work for the phoenix company.
- The assets of the failed entity are transferred by the directors at a below market value to the phoenix company.
- Preferential payments i.e. commitments relating to the payment of outstanding liabilities are made by directors to a number of the creditors of the insolvent company prior to ceasing trading.
- Substantial liabilities (e.g. tax due to state authorities) are left behind with the insolvent company which has limited assets to meet these liabilities.

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<sup>139</sup> The International Association of Insolvency Regulators is an international body that brings together the collective experiences and expertise of government insolvency regulators from jurisdictions around the world.

***Phoenix Company (Ireland)***

- One or two shareholders.
- Minimum share capital (normally two shares of €1 each with a nominal absolute maximum of 100 shares of €1 each).
- One or two directors.
- Employees are the same as is the premises from which the company trades.
- Business name on occasion is maintained by the controller of the company and may be transferred by way of licence to the new entity.

The report also notes that phoenix activity in Ireland appears in industries which require few assets but considerable input from employees. The primary sectors in which phoenix companies arise were

- construction
- transportation
- licensed premises.