client alert | explanatory memorandum

August 2016

CURRENCY:

This issue of **Client Alert** takes into account all developments up to and including 13 July 2016.

ATO small business benchmarks updated

The ATO has announced the latest benchmarks for small businesses, updated for the 2013–2014 financial year. These benchmarks are a guide to help businesses compare their performance against similar businesses in the same industry. The benchmarks can also be used by the ATO to identify businesses that may not be meeting their tax obligations.

The benchmarks:

- are calculated from income tax returns and activity statements from over 1.3 million small businesses and, according to the ATO, are verified as statistically valid by an independent organisation;
- account for businesses with different turnover ranges (up to $15 million) across more than 100 industries; and
- are published as a range to recognise the variations that occur between businesses due to factors such as location and business circumstances.

ATO Assistant Commissioner Matthew Bambrick said one of the great things about the benchmarks was that they gave a lot of small-business owners peace of mind. “If a small business is inside the benchmark range for their industry and the ATO hasn’t received any extra information that may cause concern, they can be confident that they probably won’t hear from us”, Mr Bambrick said.

Mr Bambrick said some small businesses outside the benchmark range may simply be incorrectly registered, or the business intent may have changed since starting up. “These types of small administrative errors can be easily fixed by checking the previous year’s tax return to see which business industry code was used and then updating it in the next return and on the Australian Business Register”, Mr Bambrick said.

According to the ATO, if a business is reporting above the benchmarks, it may mean the expenses of the business are high relative to its sales. This may indicate that:

- there is high wastage;
- business competitors may be able to source inputs at lower cost;
- the volume of sales is too low (for rent and possibly labour);
- the mark-up is lower than business competitors’;
- not all sales have been recorded; and/or
- internal cash controls may need to be examined.

If a business is reporting below the benchmarks, it may mean the expenses of the business are low relative to its sales. This may indicate that:

- expenses may be recorded under the wrong label;
- some expenses may have not been recorded;
- the mark-up is higher than business competitors’; and/or
- there is less wastage.

When the ATO sees that a business is outside the key ratio for the industry, it may indicate something is unusual, prompting the ATO to obtain further information from the business, its suppliers or its customers.

The benchmarks are available on the ATO website at https://www.ato.gov.au/business/small-business-benchmarks/

Source: ATO media release, "ATO benchmarks helping build small business", 24 June 2016, https://www.ato.gov.au/Media-centre/Articles/ATO-benchmarks-helping-build-small-business/.

ATO benchmarks in action

If a business doesn't have evidence to support its return, the ATO may use the benchmarks to determine income that has not been reported. For each industry, the ATO will highlight the benchmark it will use to predict income or turnover.

The following recent Administrative Appeal Tribunal (AAT) case highlights the ATO's use of industry benchmarks.

Income tax and GST and associated penalties broadly affirmed

The AAT has affirmed the Commissioner's income tax and associated penalty decisions imposed on a taxpayer. However, it also decided to vary the GST and associated penalty decisions to reflect a reduced GST liability, as conceded by the Commissioner before the hearing.

Background

The taxpayer operated a milk bar and contended it also operated a business providing homestay accommodation for foreign students. Following an ATO audit, the Commissioner was not satisfied that the taxpayer had reported its true taxable income for the 2010–2011 and 2011–2012 income years, nor that the taxpayer had reported its true GST net amounts for the quarterly periods from 1 April 2010 to 30 June 2012. The evidence of sales and purchases manually kept in books and cash register roll totals did not reconcile to the taxable amounts reported, and were less than the amounts the Commissioner contended could be expected if industry norms or expectations were applied to the purchases reported.

In this case, the Commissioner applied the tobacco retailing industry benchmarking figures to determine the taxpayer's business income. The Commissioner did not accept that the taxpayer operated a homestay business and excluded all reported income and expenses relating to homestay activities. The Commissioner also disallowed expenses relating to two cars, and purchases that were not supported by a valid tax invoice. The amounts in dispute before the AAT totalled some $27,000 (primary tax and penalties).

Decision

The AAT held the taxpayer had failed to discharge the onus of proving that the income tax and GST assessments and amended assessments were excessive. The AAT was of the view there was a lack of evidence to prove otherwise. It said, "The combination of the accounts book, invoices led in evidence, inconsistent cash register rolls and absence of commitment to amounts of taxable income and supplies, or particular sources from which these amounts can be determined with confidence, make determination of the [taxpayer's] taxable income and supplies little, if at all, more than guesswork. This being the case, it is impossible to say by what amount the assessments are excessive."

The AAT also affirmed the penalty imposed for failure to take reasonable care. Among other things, the AAT heard the taxpayer's evidence that taxable income amounts were made up as it was told (allegedly) by its tax agent that the ATO did not like to see losses, so that would bring unwanted attention. In affirming the penalty decisions, the AAT said, "In circumstances where a fabricated income figure is used in relevant tax filings it is difficult to see how reasonable care could be demonstrated. Further, there being no evidence of what the tax agent did or did not do makes a finding that the tax agent took reasonable care impossible to make." The AAT also concluded that there were no grounds for remission.

In making its decisions, the AAT noted the outcomes of the case should not be taken as acceptance of whether the taxpayer did (or did not) carry on a homestay business.

Accordingly, the AAT affirmed the income tax and associated penalty decisions noting the Commissioner's "concession" to vary the GST and associated penalty decisions to allow further input tax credits in respect of a small range of acquisitions.

Re H J International Trade Group Pty Ltd and FCT [2016] AATA 450, *http://www.austlii.edu.au/au/cases/cth/AATA/2016/450.html.*

SMSF early voluntary disclosure service for contraventions

The ATO has introduced a new self managed super fund (SMSF) early engagement and voluntary disclosure service.

Each year, an approved SMSF auditor must audit the fund. The auditor is required to report certain regulatory contraventions to the ATO via the auditor/actuary contravention report (ACR). The ATO encourages SMSF trustees to voluntarily disclose regulatory contraventions, which they can now do using the ATO's SMSF early engagement and voluntary disclosure service. This service provides a single entry point for SMSF trustees and professionals to engage early with the ATO in relation to unrectified contraventions. SMSF trustees, SMSF auditors and SMSF professionals (such as tax agents, accountants, financial planners, lawyers and fund administrators acting on behalf of SMSF trustees) can use the service.

The ATO says the new disclosure service should only be used when it is clear there has been a contravention of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) or regulations that remains unrectified at the time the SMSF auditor reports it to the ATO. Before using this service, the ATO says, trustees should engage with an SMSF professional to receive guidance about rectifying the contravention so they have a rectification proposal to include with their voluntary disclosure.

The SMSF auditor is still required to report regulatory contraventions via an ACR. However, the ATO says it will not commence an audit based on an ACR if the issue has been resolved through a voluntary disclosure, unless it receives additional information that requires further investigation.

The ATO warns that SMSFs should not use this service if they have already received notification of an ATO audit or review in relation to the contravention. The ATO also notes that where disclosures are made about contraventions that occurred in previous years, any outstanding SMSF annual returns must be lodged.

Source: ATO, SMSF early engagement and voluntary disclosure service, 26 May 2016, https://www.ato.gov.au/Super/Self-managed-super-funds/Administering-and-reporting/How-we-help-and-regulate-SMSFs/SMSF-early-engagement-and-voluntary-disclosure-service/.

ATO case studies

The ATO has provided the following case studies to illustrate the benefits of its early engagement and voluntary disclosure service.

Example 1: overdrawn bank account

The Stephens Superannuation Fund bank account was overdrawn twice during the 2014–2015 financial year. After rectifying the breach, the trustee engaged an SMSF auditor and disclosed the breaches to ATO via the SMSF early engagement and voluntary disclosure process.

The ATO advised the trustees that, given that the contraventions were rectified, there was no need for them to use the service. By raising the breaches with their approved auditor they had discharged their reporting obligations. The trustees also put controls in place to prevent the fund bank account being overdrawn in the future.

Given it was a reportable contravention, the SMSF auditor lodged an ACR. As a result of the ACR, the ATO sent an education letter to the fund in relation to the breach.

Example 2: breach of LRBA rules

The approved auditor for trustees Emma and Jonas Klein identified a limited recourse borrowing arrangement (LRBA) breach in relation to the Klein Superannuation Fund for the 2014–2015 financial year.

The breach arose because the Klein Superannuation Fund entered into an LRBA that had not been structured correctly. A holding trust did not hold the property on trust for the fund trustees and the LRBA was with a non-related party. The trustees made a voluntary disclosure of the breach and provided all relevant facts and supporting documentation. They also provided a proposed undertaking to rectify the contravention within six months.

The trustees actively engaged with the ATO throughout the resolution process and lodged the outstanding returns. The Commisisoner accepted their undertaking to rectify the contravention. The terms of the enforceable undertaking were that the property was to be transferred into the holding trust within six months. SMSF administrative penalties were imposed and remitted in full, given that the trustees made a voluntary disclosure.

Example 3: money lost in investment scam

The trustees made an SMSF voluntary disclosure that the Okafor Superannuation Fund had not lodged annual returns for four years because all its money was lost in an investment scam. The trustees made their disclosure prior to the notification of an ATO SMSF review or audit and provided all relevant facts and supporting documentation, including bank statements. The trustees provided an undertaking to wind up the fund and not to act as trustees of another SMSF in the future.

The trustees actively engaged with the ATO throughout the process and the ATO verified the investment scam claims. The Commissioner accepted the undertaking and the SMSF was wound up.

Source: ATO, "Early engagement and voluntary disclosure", 27 May 2016, https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/SMSF-resources/SMSF-case-studies/Early-engagement-and-voluntary-disclosure/.

New tax governance guide for SMSFs

When managing an SMSF, trustees need to apply a high level of governance to meet the requirements of both the income tax and super laws. The ATO has released a new tax governance guide for use by SMSFs. The ATO says it has been working with businesses, tax advisers and agents to design the guide and help private groups with tax governance.

The ATO says SMSF trustees and professionals can use this guide to develop an effective governance framework and identify ways to improve existing governance practices within their SMSFs.

Issues covered in the guide include:

- corporate governance and tax governance;
- starting your business;
- business expansion;
- funding and finance;
- philanthropy;
- succession planning;
- exiting a business;
- retirement planning, including SMSFs and CGT small business concessions; and
- estate planning.

Among other things, the guide says that SMSF trustees must ensure that their funds meet the definition of an SMSF at all times and remain complying. This includes meeting requirements for fund structure, members and trustees; and governing fund compliance with rules for contributions, investments and payment of benefits. Where an SMSF auditor or other adviser identifies issues with a fund's compliance, trustees should take immediate steps to correct them, the ATO warned.

The fund's financial statements and regulatory compliance need to be audited before the SMSF annual return is lodged. An audit is required even if no contributions or payments are made in the financial year. The ATO recommends that trustees ensure all documents are provided to the SMSF auditor with sufficient time for the audit to be completed within the legislated period.

The ATO encourages trustees to work closely with their SMSF advisers and auditors. The auditor will give the trustee a report on their SMSF's regulatory compliance, including any contraventions. Any material contraventions must be reported by the auditor to the ATO. Trustees should also periodically verify that their SMSF satisfies the requirements of a regulated super fund, including requirements around contributions, investments and paying out benefits.

The ATO suggests that trustees formulate an exit strategy so they are prepared should the time come that they no longer want an SMSF and need to wind it up. Matters such as disposal of assets, paying out or rolling over benefits, arranging the final audit, lodging the final SMSF annual return, paying outstanding tax, closing bank accounts and cancelling ATO registrations should be considered.

Source: ATO, "SMSF governance", 31 May 2016, https://www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/Tax-governance/Retirement-planning/Self-managed-super-funds/.

Property developer entitled to capital gain tax concession

A taxpayer has been successful before the AAT in arguing that a commercial property it acquired and developed and later sold for a profit of some $40 million had been acquired as a capital asset to generate rental income, and not for the purpose of resale at a profit – despite the fact that the AAT indicated the taxpayer was essentially involved in "property development" activities on a broad analysis of its activities. As a result, the AAT found that the profit of $40 million was assessable as a capital gain and entitled to the CGT 50% discount.

In coming to this conclusion, the AAT noted that even though the taxpayer's property development business involved purchasing properties for resale at a profit, the business carried on by the taxpayer involved far more than this. A "wide survey and an exact scrutiny of the activities" of the taxpayer showed that over a 40-year period they involved everything from the acquisition, development and sale of residential properties to the acquisition and development of commercial properties to hold as capital assets for the purpose of deriving rental income. As a result, the AAT rejected the Commissioner's basic claim that the taxpayer was carrying on "a business of the acquisition, development and disposal of properties for a profit".

Moreover, the AAT found that in relation to the "discrete" transaction in question (which it was required to consider for the purpose of determining the issue), all the evidence pointed to the fact that the taxpayer intended to develop the original vacant car park into commercial property to lease to government agencies, for which there was growing demand at the time. This evidence included:

- the uncontradicted evidence of the father and son controllers of the business (who historically had adopted the approach of individually assessing the best profitable use of a particular property and then putting the property to that use);
- contemporaneous bank records (which noted that the building was to be "retained on completion for investment");
- that a 15-year lease agreement was originally entered into; and
- that the intention to eventually sell (despite the father's original resistance and his historical preference to generate income by rental returns) was because the offer to sell "was simply too good".

In this regard, the AAT also noted that as part of the sale deal, the purchaser offered the taxpayer the opportunity to acquire substitute investment commercial properties – and that the three properties subsequently acquired by the taxpayer as part of this arrangement were still owned by the taxpayer, almost nine years after the relevant transaction. In arriving at its decision, the AAT noted that it is always possible that the owner of an asset will sell it, "but to elevate that possibility into an intention to make a profit by selling the property is to draw a long bow indeed" – particularly in the circumstances of this case and given the nature of the transaction in question.

Accordingly, the AAT found that while the transaction by which the property was disposed of was not a transaction undertaken in the ordinary course of the taxpayer's business activities, having regard to the overall wide scope of its business activities, in terms of examining the specific transaction and its "discrete" nature, nor was the property acquired for the "purpose of profit-making by sale". As a result, the AAT concluded that the profit from its sale was to be accounted for as a capital gain and not revenue profit.

Re FLZY and FCT [2016] AATA 348*, , 27 May 2016, www.austlii.edu.au/au/cases/cth/AATA/2016/348.html.*

Superannuation concessional contributions caps must be observed

An individual taxpayer has been unsuccessful before the AAT in seeking to have excess concessional contributions for the 2014 financial year disregarded or reallocated pursuant to s 291-465 of ITAA 1997.

Background

The taxpayer was a full-time employee in the Victorian Public Service and also worked a number of part-time, casual jobs with approximately four employers. As at 30 June 2014, he was 56 years of age and his concessional superannuation cap was $25,000. He salary sacrificed $100 per week of his full-time earnings into one super fund and salary sacrificed all of his casual earnings with another super fund. The taxpayer did not check his super fund balances.

In June 2015, the taxpayer received a notice of amended assessment for the 2013–2014 financial year that included excess concessional contributions of $11,055. The amended assessment detailed the increase of taxable income from $88,075 to $99,130, an excess concessional contributions tax offset of $1,658 and an excess concessional contributions charge of $250. The taxpayer had previously received a notice of assessment for 2012–2013 financial year detailing excess concessional contributions of $7,656 and excess concessional contributions tax of $2,411.

The taxpayer submitted that he worked additional casual jobs and salary sacrificed his super to provide for his retirement and for his family. He did not have the predictability of knowing what he would earn through his casual jobs, which depended on having shifts allocated. The taxpayer submitted that the rules were difficult to comprehend and he had made an inadvertent mistake. Had he been aware he was approaching his concessional super contribution cap, the taxpayer submitted that he would have stopped the salary sacrifice arrangements, and that his ultimate tax bill would have been the same, albeit the tax bill would have been met by PAYG deductions over time.

Decision

The AAT said, "In a system where there are limits on what can be contributed to a superannuation fund while retaining concessional treatment, to waive compliance in this case would effectively provide [the taxpayer] with an advantage in the form of being allowed to contribute extra to his superannuation funds, and to enjoy the benefit of that without any cost associated with the excess, to the advantage of other taxpayers in the community who observe the limits."

The AAT said that while the taxpayer's "motives for working hard and stowing money away for retirement income are admirable, his predicament [did] not amount to a special circumstance". It added that inadvertent mistakes were not special circumstances and that the "complexities of the system of taxation of retirement income and providing for retirement income are complexities the whole community has to deal with". Accordingly, the AAT affirmed the Commissioner's decision.

Monitoring the limits: taxpayer's submission

During the hearing, the taxpayer suggested that the ATO might do more to advise what was required. The taxpayer suggested that in other settings there are apps available for use with modern technology that let people know their progressive use of facilities such as data volume downloaded from the internet, and something similar could be adopted in a taxation setting. The AAT said that submission was not for it to deal with; however, it suggested that it was "possibly one that the ATO might wish to explore for the future".

Re Azer and FCT [2016] AATA 472*, 4 July 2016, www.austlii.edu.au/au/cases/cth/AATA/2016/472.html.*

Help the kids buy homes, but watch for land tax

A taxpayer has been unsuccessful before the Queensland Civil and Administrative Tribunal (QCAT) in arguing that there was a "constructive trust" in relation to three properties.

Background

The taxpayer had purchased three residential properties, one for each of his three children to live in. There were agreements that the children would pay their parents rent and, upon the death of both parents, as specified in mutual wills, the properties would each be left to the respective child.

The Commissioner assessed land tax on the aggregate value of the three properties as at 30 June 2013 and 30 June 2014 respectively. The taxpayer objected, arguing that he was the trustee of each property for each child and that land tax (if any) should be assessed separately in respect of each property. The Commissioner contended that there was no "constructive trust" as was argued by the taxpayer, and that the taxpayer – as "owner" of the land – was liable to land tax on an aggregate basis.

Decision

The QCAT affirmed the Commissioner's decision, holding that the taxpayer was the "owner" of the properties and it was not convinced that there was a "constructive trust". Therefore, s 20(1) of the *Land Tax Act 2010* (Qld) to separately assess trust land did not apply. However, in doing so, the QCAT hinted at the possibility that in future assessments the taxpayer could, on sufficient evidence, persuade the Commissioner or QCAT otherwise. It also noted the possibility of a future express declaration of trust with consequential changes to the wills, which could affect future land tax liabilities.

Harrison v Comr of State Revenue [2016] QCAT 150*, http://archive.sclqld.org.au/qjudgment/2016/QCAT16-150.pdf.*

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