client alert | explanatory memorandum

February 2017

CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 13 January 2017.

ATO priority on settling cases – but not at any cost

The ATO places a high priority on resolving disputes early, including through settlements where appropriate. While the ATO says it does not settle disputes at any cost, it says “the sensible use of settlements” is part of its commitment to earlier and more effective dispute resolution.

The following interesting statistics reveal the ATO’s use of settlements:

- In 2015–2016, the ATO settled 1,362 cases, 31% more than in the previous year. The ATO said the increased number can be attributed entirely to settlements finalised as part of Project DO IT (Declare Overseas Income Today). In all, there were 676 Project DO IT settlements, making up about 50% of the total number of cases settled. Each of these settlements occurred at the earliest stages, with a focus on prevention to avoid unnecessary and ongoing disputes.
- In 2015–2016, 95% of settlements occurred prior to litigation, compared to 84% in 2014–2015.
- In 2015–2016, the number of large business settlements declined significantly to 27, down from 81 in 2014–2015. This compares with 34 settlements in 2013–14 and 27 in 2015-16. The ATO said the relatively large number of settlements in 2014–2015 can be attributed to the resolution of some longstanding large business matters.
- In 2015–2016 settled cases, the ATO position prior to settlement was $2.457 billion, while the settled position totalled $1.571 billion – a difference of $886 million. The ATO points out that as settlements involve amounts that are necessarily uncertain, especially where a settlement is reached at the audit or pre-audit stage (ie before an assessment), pre-settlement position amounts may not reflect actual liabilities. The settled amounts reflect agreed revenue that will be paid now and into the future, as opposed to potential *prima facie* amounts that could be subject to protracted and costly delay through litigation, remaining unpaid and with no certainty of outcome.

Source: ATO, Settlements, 23 November 2016, https://www.ato.gov.au/General/Dispute-or-object-to-an-ATO-decision/In-detail/Avoiding-and-resolving-disputes/Settlement/Settlements/.

ATO develops work-related expenses risk profiles

The ATO has developed work-related expenses risk profiles to help identify how work-related expense (WRE) deduction amounts compare for similar taxpayers. According to the ATO, 8.4 million taxpayers claimed a total of $21.3 billion in WREs in 2015, and the amounts claimed continue to grow.

Complex rules and uncertainty about their applicability to individual circumstances can make WRE entitlements difficult to understand, so it is an area where taxpayers often make mistakes. While the amounts mistakenly claimed are relatively small at an individual level, collectively the overall impact can be significant.

According to the ATO, improvements in data analytics and modelling have allowed it to create risk profiles for tax agents’ practices based on a comparison of their clients’ WRE claims with those made by similar taxpayers.

Over the next few months, the ATO says it will share these risk profiles with some tax professionals where their clients’ claims appear higher than expected. This doesn’t necessarily mean these tax professionals are doing anything wrong – the ATO says risk profile is just one of the factors it will use to monitor WRE claims.

Source: ATO, Work-related expenses risk profiles, 29 November 2016, https://www.ato.gov.au/Tax-professionals/Newsroom/Your-practice/Work-related-expenses-risk-profiles/.

Onus on taxpayers to show no fraud or evasion: Full Federal Court

Four taxpayers have been unsuccessful in their appeals before the Full Federal Court, in which they challenged assessments that dramatically increased their assessable income for certain income years. The central issue in each case was whether, in circumstances where the Commissioner has issued an amended assessment out of time on the grounds of "fraud or evasion", the taxpayer in question bears the onus of proving the absence of fraud or evasion"". One case also concerned the issue of whether the Commissioner could issue assessments after the death of the taxpayer (in respect of income earned before their death), and another also concerned the issue of whether the taxpayer had been denied procedural fairness.

Margaret Binetter v FCT

This matter involved amended assessments issued to the taxpayer for the 2002 to 2007 income years which increased her assessable income by some $1.5 million (plus penalties). In this case, the Commissioner had formed the opinion that "evasion" had occurred which justified issuing the amended assessments out of time. In *Re Bennett and FCT* [2015] AATA 455 (proceedings conducted under a pseudonym), the AAT had ruled that the taxpayers had not discharged the onus of proving that assessments made against them were excessive, and that this included the taxpayer's failure to prove there had been no "fraud or evasion". In dismissing the taxpayer's appeal from that decision, the Full Court unanimously confirmed that it was for the taxpayer to discharge the onus that that there was no fraud or evasion and that it did not matter that the assessments were raised as default assessments.

Andrew Binetter v FCT

This matter likewise involved amended assessments issued to the taxpayer out of time, except that in this case the Commissioner did so on the basis that there had been "fraud or evasion" (not just "evasion"). However, the Full Court unanimously ruled, on the arguments before it, that there was no difference to amended assessments raised out of time on the basis of "evasion" alone or "fraud or evasion". Accordingly, it likewise determined that the taxpayer had failed to establish the onus of proving that the assessments were excessive, including in respect of the "fraud or evasion" issue.

Margaret Binetter for estate of Erwin Binetter v FCT

This matter involved the issue of whether a taxpayer could be liable for tax on income that is earned during their lifetime, but is not assessed until after their death. The Full Court unanimously ruled that a taxpayer could be liable for tax in these circumstances and that, as a result, amended assessments issued to the estate of the deceased taxpayer in respect of income earned during the deceased's lifetime were effective (again, despite some of them being issued out of time on the basis of "fraud or evasion").

In short, the Full Court concluded that an "outstanding tax-related liability" (as defined in the tax law and relevant to the matter) includes tax on income earned by a deceased person but not assessed during their lifetime – even though the debt itself is not recoverable until the assessment that sets out the specific amount owing and its due date for payment has been issued to the estate of the deceased taxpayer.

In any event, the Full Court found that the Commissioner had complied with the procedures contained in s 260-145 of Sch 1 to the *Taxation Administration Act 1953* (TAA) for the recovery of tax from "unadministered estates" (as in this case) and therefore it was not strictly necessary to consider whether an "outstanding tax-related liability" encompasses an as-yet unassessed tax liability.

The requirements in s 260-145 require the Commissioner to determine the "outstanding tax-related liability" of the deceased and to publish notices in daily newspapers that the liability existed. These notices then are conclusive evidence of the liability, unless it is challenged by a person with an interest in the estate or by a person who has been granted probate. In this case the notice was challenged by the deceased' taxpayer's wife, but her objection and later application to the AAT were dismissed.

FCT v Tao Bai

This matter involved an amended assessment being issued to the taxpayer out of time on the basis of "fraud or evasion" which increased her taxable income for the 2005 year from $13,000 to $1.1 million (plus 50% shortfall penalties). Before the AAT in *Re Bai and FCT* [2013] AATA 612, the taxpayer had been only partly successful in arguing that the bank deposits which gave rise to the amended assessment were not income. However, in *Bai v FCT (No 2)* [2015] FCA 1083, the Federal Court found that the AAT had wrongly applied the "criminal standard of proof" (in view of the AAT statement, "I am not satisfied that evasion was not present"), and consequently remitted the matter for rehearing.

The current matter was the Commissioner's appeal against that decision, and also involved the taxpayer arguing (again) that she had been denied "procedural fairness" – she claimed that records had been seized which were necessary for her to discharge the onus of proving that the assessments were excessive. The taxpayer also argued that it was for the AAT to form its own view about the existence of "fraud or evasion".

In relation to the "procedural fairness" issue, the majority of the Full Court found that the taxpayer had not been denied procedural fairness, mainly because her affidavit evidence before the AAT did not rely on the

records seized and it was only when she "went off piste" from this affidavit evidence that such records were relevant. In any event, the Court noted, the ATO indicated that the relevant records would have been made available to her if she had informed it she would be relying on them in her case. Siopis J dissented, essentially on the basis of the adverse effect for the taxpayer arising from the absence of documentary evidence to corroborate the "assertions" she made in her oral evidence.

In relation to the "criminal standard of proof" issue, the Full Court unanimously agreed with the Commissioner that "the reasons of an administrative decision-maker should not be examined minutely" to find error. It also agreed that even if the AAT had impermissibly applied a higher standard of proof, this was immaterial – the relevant AAT statement arose from its earlier conclusion that it did not accept the taxpayer's explanations of the deposits' source, and that therefore the taxpayer had not discharged the onus of proving, on the balance of probabilities, that the assessment was excessive.

Finally, in relation to the "fraud or evasion" issue, the Full Court again unanimously confirmed that the onus was on the taxpayer to show that there was no fraud or evasion.

Binetter v FCT [2016] FCAFC 163, Full Federal Court, Siopis, Perram and Davies JJ, 2 December 2016, http://www.austlii.edu.au/au/cases/cth/FCAFC/2016/163.html.

No disclaimer of trust interest: unsuccessful appeal

A beneficiary of two trusts whose assessable income was increased from some $70,000 to some $13 million in respect of her entitlement to distributions from the trusts has been unsuccessful before the AAT in arguing that she had "disclaimed her interests" in the trusts.

Background

The taxpayer was a beneficiary of two trusts, one of which ("Archer") was involved in investments in residential complexes in partnership, or as a "syndicate member", with another entity. Following an audit of the trusts (and an earlier settlement arrangement), Archer was denied deductions for significant "syndication" costs it had previously incurred, while the second trust ("Shee") was likewise denied significant deductions. The effect of these adjustments was to substantially reduce the deductible carried-forward losses of the trusts.

As a result, in May 2013 amended assessments for the 2006 and the 2007 income years were also issued to the taxpayer, as she was the beneficiary of the trusts and was entitled to 100% of the trust income from them. The amended assessments increased her taxable income from $9,000 to $10 million in the 2006 income year and from $60,000 to $3 million in the 2007 income year. In addition, a shortfall interest charge (SIC) of $3.2 million was imposed, as reduced by the Commissioner over certain periods of the audit and assessment process.

The taxpayer unsuccessfully objected to the amended assessments, and before the AAT argued the following:

- a "disclaimer of trust interests" she entered into in December 2015 was effective to disclaim any entitlement to the trust distributions;
- the Archer trust resolution to distribute "income" of the trust to the taxpayer was not valid in terms of the Archer trust deed;
- "default" resolutions made by both trusts to distribute the trust income to another party in the event that their deductions were denied by the ATO were valid and effective;
- the amended assessments were issued out of time;
- the denied carried-forward losses were in fact available to Archer; and
- the SIC should be remitted.

Decision

In dismissing the taxpayer's application on all grounds, the AAT found as follows.

Disclaimer of trust interest

The AAT ruled that because the taxpayer had not specifically raised the disclaimer issue in her grounds of objection, it would not be permissible to raise it in the application before the AAT. In arriving at its decision, the AAT also noted that, among other things, the relevant parties had had the benefit of the distributions, there was a significant passage of time between the distributions and the making of the disclaimer, and the taxpayer's husband (who managed the affairs of the trusts) could have arranged for the otherwise "retrospective" disclaimers to be made before the amended assessments had issued. Furthermore, the AAT found that it would not be in the interests of justice to give the taxpayer leave to extend the grounds of her objection, given that the objection never touched on the issue of disclaimer.

Validity of Archer trust resolution

The AAT concluded that the resolution made by the Archer trust to distribute the "income" of the trust to the taxpayer was not an invalid exercise of its power merely because it referred to "income" and not "net income" of the trust. Likewise, the AAT found that leave should not be granted to the taxpayer to expand the grounds of her objection to include that the Archer resolution was ineffective to distribute income to her. This was because the AAT said that the Commissioner would be "prejudiced" by such leave – he could have instead issued an assessment to Archer, making it liable for the tax on the trust income under s 99A of the *Income Tax Assessment Act 1936* (ITAA 1936).

Validity of the default resolutions

The AAT also found that the "default" resolutions were not effective because neither they nor the "initial" resolutions were technically subject to a "contingency". The initial resolutions clearly intended, and had the effect of, making the taxpayer entitled (both in "interest" and "possession") to the whole of the income of the trusts – which, furthermore, was the "practical effect" of the resolutions. In addition, the AAT noted that the effect of the initial resolutions meant there was nothing left to be distributed under the default resolutions.

Assessments out of time

The AAT found that the amended assessments had not been issued to the taxpayer out of time as she had, in terms of s 170(7), item 4 of the ITAA 1936, consented to a relevant extension to the limitation period. She had done so in response to the Commissioner's request for such an extension, which was made during the audit process involving the taxpayer's tax affairs.

Carried-forward losses

The AAT confirmed that the carried-forward losses had been correctly denied by the Commissioner. This was because the evidence indicated that deductions had been appropriately reduced for the amounts "actually incurred" in the relevant year by Archer in respect of the purchase of property by the syndicate, and for which it was claiming a deduction for its share of the outgoings as a syndicate member.

SIC remission

Finally, the AAT found that there was no grounds for further remission of the SIC imposed by the Commissioner. In doing so, it dismissed the taxpayer's arguments that she was unaware of the trust distributions or of the trusts themselves. The AAT noted that she had placed entire responsibility for her taxation and financial affairs on her husband, who was also her tax agent.

Re TVKS and FCT [2016] AATA 1010, AAT, Ref No: 2015/4655- 4656, Forgie DP, 9 December 2016, http://www.austlii.edu.au/au/cases/cth/AATA/2016/1010.html.

Admin penalties of 75% for failing to lodge FBT returns

The AAT has confirmed 75% administrative penalties were rightfully imposed on three companies for their failure to lodge FBT returns over a four-year period. In doing so, the AAT found the Commissioner was obliged to impose the penalties, and that the "safe harbour" provisions did not apply. It also found it was not appropriate for the AAT to exercise its discretion to remit the penalties in part or whole under the circumstances.

Background

The taxpayers were three companies that were in effect owned and controlled by one director. Following an audit and their failure to comply with the Commissioner's request to lodge FBT returns by a specified date, the Commissioner raised default FBT assesments to the taxpayers over four years in relation to several luxury cars provided by the taxpayers, resulting in an overall liability of over $620,000. The assessments imposed 75% administrative penalties of over $250,000 under s 284-75(3) of Sch 1 to TAA 1953 for the companies' failure to lodge their FBT returns. The taxpayers unsuccessfully objected to the assessments, the imposition of the penalties and the Commissioner's failure to exercise his discretion to remit them.

Before the AAT, the taxpayers contended, among other things, that the discretion to remit the penalty should be exercised on the basis that the director had entrusted his accountant (and part-business partner) with financial management of the companies, including all their tax compliance obligations, but that he had "completely and singularly failed to discharge his professional obligations"; otherwise, the director contended, he had no knowledge of the companies' FBT compliance obligations.

The Commissioner argued that the taxpayers were given more than ample time to lodge the outstanding FBT returns when directed to do so by the ATO, and that there was no discretion to impose any other rate than the 75% base penalty rate under s 284-90(1) (item 7) in circumstances where the administrative penalty was imposed under s 284-75(3) for failing to lodge FBT returns.

Decision

In agreeing with the Commissioner, the AAT emphasised that all the requirements for imposing a penalty under s 284-75(3) had been complied with. It also noted that the failure to lodge FBT returns by the date required meant the Commissioner instead had to determine the companies' liability to pay FBT in the absence of a tax return. The AAT emphasised that there was no discretion to impose any base penalty rate other than the 75% base penalty amount where the administrative penalty was imposed under s 284-75(3), and that the "safe harbour provisions" in s 284-75(6) were not applicable to an administrative penalty imposed under s 284-75(3).

In relation to remission of the penalty, the AAT ruled that "severity or harshness" is not a requirement for remission. It further found that the criteria in PS LA 2014/4 provided relevant guidance on the matter, as it had the benefit of achieving consistency in decision-making, and that it also accorded with the Federal Court's decision in *Sanctuary Lakes Pty Ltd v FCT* (2013) 212 FCR 483. In this regard, the AAT noted among other things that:

- there was no "mistaken belief" on the part of the taxpayers that FBT lodgment was not required – especially as their tax agent had been registered since 1987 and a chartered accountant since 1988; furthermore, he could not have been in any doubt about the requirement to lodge FBT returns after receiving the request from the ATO requesting lodgment by a certain date;
- the taxpayers failed to manage or make appropriate efforts "to understand and comply with" their FBT lodgment obligations – their failure to lodge the FBT returns as required was not due "to circumstances beyond their control";
- there was no "unjust result" in not remitting the penalties, especially in view of the accountant's unsatisfactory explanation for failing to lodge the FBT returns by the requested date and the director's "retrospective completion of log books";
- the taxpayers did not provide the requisite level of cooperation at any time (in terms of, for example, failing to make voluntary disclosures at an earlier meeting with the ATO and creating a log book "after the events"); and
- there was no evidence that the ATO's actions had been "inconsistent" in its dealings with the taxpayers during the course of the matter.

Accordingly, the AAT affirmed the Commissioner's decision under review. In doing so, the AAT stated that the taxpayers failed in their onus to prove that the remission decision should have been made differently.

Re GSLL and FCT [2016] AATA 954, Re MKDZ and FCT & Re ZZSW and FCT, AAT, Ref Nos 2015/3760-3763, 2015/3764-3767, 2015/3769-3770, McDermott DP, 29 November 2016, http://www.austlii.edu.au/au/cases/cth/AATA/2016/954.html.

New ATO data-matching program: ride sourcing

The ATO will acquire data to identify individuals who may be engaged in providing ride-sourcing services during the 2016–2017 and 2017–2018 financial years. Details of all payments made to ride-sourcing providers from accounts held by a ride-sourcing facilitator will be requested from the facilitator's financial institution for the 2016–2017 and 2017–2018 financial years. Ride-sourcing facilitators (eg Uber) provide an electronic platform that enables members of the public to engage the services of a ride-sourcing provider (a driver). The ATO estimates that up to 74,000 individuals offer, or have offered, services as ride-sourcing drivers.

The ATO will match the data provided by each facilitator's financial institution against ATO records. This process is designed to identify ride-sourcing drivers who may not be meeting their registration, reporting, lodgment and/or payment obligations. Where the ATO is unable to match a driver's details against ATO records, it will obtain further information from the financial institution where the driver's account is held.

Source: ATO, Ride sourcing – 2016–17 and 2017–18 data matching program protocol, https://www.ato.gov.au/general/gen/ride-sourcing-2016-18-data-matching-protocol/.

Taxation Ruling on commercial website deductibility

On 20 December 2016 the ATO issued Taxation Ruling TR 2016/3, which sets out the deductibility of expenditure incurred in acquiring, developing, maintaining or modifying a website for use in carry on a business. The Ruling also covers the deductibility of expenditure on content migration, development of microsites, social media accounts, domain names and copyright. However, it notes that assets such as hardware, the right to use the domain name, and content that has independent value to the business are identified separately and are not considered a part of a commercial website.

According to the ATO, expenditure in relation to commercial websites includes labour, off-the-shelf software products, registration, licensing and other periodic usage fees. Generally, it states that where the expenditure (labour, software, registration, etc) is directly referable to the enhancement of the profit-yielding

structure of the business, it would be considered capital. Specifically in relation to off-the-shelf software products that are licensed periodically, or where a website is leased from a web developer and the business does not have a right to become the owner of the website, any expenses incurred are likely to be of a revenue nature, the Ruling states.

The Ruling indicates that expenses incurred to acquire or develop a commercial website for a new or existing business are considered to be capital, and that maintaining a website, including remedying software faults, is a revenue expense. It notes that any modification to a website that adds new functionality to both back-end and front-end (ie interactivity available directly to the website or management of background operations) or materially expands existing functionality is capital. However, the Ruling says that expenditure on regularly upgrading existing website software to allow web pages to appear correctly with new mobile devices, browsers or operating systems is generally considered deductible, as it is considered to be operational and directed at facilitating continued access. Similar principles apply to determining whether expenditure incurred in acquiring or developing a microsite is of a capital or revenue nature; however, expenditure on a temporary microsite is more likely to be of a revenue nature where it is set up for a transient marketing purpose.

In some instances, the Ruling says, modifications to a website may be made in a piecemeal manner but may together result in a significant improvement to the website. Some indicators that piecemeal modifications are part of a program of work for improving the website (and thus considered capital) include documentation for a program of work; the extent to which the end-state is planned, and the importance of incremental enhancements to achieving that end-state; and casual or temporal links with other modifications.

In relation to content migration, the Ruling indicates that if content is migrated as part of establishing a new website, the cost is capital. However, it says if content is migrated as a part of a website upgrade, the cost is capital if the upgrade itself is capital, but otherwise it is a revenue expense. Further, the Ruling states that the migration of content due to replacement of hardware without a material change to the commercial website is a revenue expense.

According to the Ruling, establishing a presence on a social media website is a capital asset that is separate from a business's website, and is not "in-house software", as it resides on the social media platform. Expenditure incurred on the profile may be treated as a revenue expense where the cost of setting up the profile is trivial and the profile is maintained for marketing purposes.

Where a business's website costs are not otherwise deductible under s 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997), the expenditure may be classed as "in-house software" and deductible under the capital allowances regime. The Ruling states that:

- expenditure may be deducted over five years from the time the software is first installed or ready for use;
- the expenditure may be allocated to a software development pool; or
- small business entities may choose to use the simplified depreciation rules in Subdiv 328-D of ITAA 1997 (ie immediate write-off where asset cost is under the threshold or depreciated in accordance with general small business pool rules).

In-house software

The Ruling defines in-house software to include:

- software in a commercial website that enables the website owner to interact with the user, where any independent benefit to the user is no more than incidental to the interaction;
- software provided on a commercial website for installation on the user's device if its purpose is solely to provide a user interface with the business; and
- content on a website which is incidental to the website and not an asset having value separate from the website.

The Ruling also outlines what is considered not "in-house software".

CGT issues

Where business website costs are deductible under neither s 8-1 nor under the capital allowances regime, the CGT regime will recognise the expenditure as a part of the cost base of a CGT asset, the Ruling states. It also states that s 40-880 of ITAA 1997 will generally not apply (as it is a provision of last resort), since commercial websites will usually be considered "in-house software" or, if not, are likely to be part of the cost base of a CGT asset.

In relation to domain names, an amount paid once-and-for-all to secure the right to use a domain name is capital expenditure and the right to use a domain name is a CGT asset; thus, the right to use a domain name forms part of the cost base of that asset. However, the Ruling notes that periodic registration fees for a domain name, including the initial registration fee, are revenue expenses and are deductible when paid, unless the fees relate to a period greater than 13 months, in which case the expenditure is deductible over the period to which the fee relates.

Copyright

The Ruling notes that copyright can subsist in parts of a website, but not in a website as a whole. Hence, it states where a website owner holds copyright in a component of the website held for taxable purposes, the decline in value of the copyright may be deducted. If the component is both copyright and a part of an in-house software asset, the most appropriate treatment will be to deduct the decline in value of the in-house software asset. The Ruling also says that copyright in software or content is not considered a part of the website, and whether the copyright can be depreciated will depend on whether the commercial website expenditure can be depreciated.

Previous draft

The Ruling was previously issued as Draft Taxation Ruling TR 2016/D1; the current Ruling contains significant changes. It contains 25 examples (also significantly changed from the draft) to illustrate the deductibility of expediture in various scenarios.

Date of effect

Taxation Ruling TR 2016/3 applies to income years commencing before and after its date of issue (20 December 2016).

Source: ATO, Taxation Ruling TR 2016/3, 20 December 2016, https://www.ato.gov.au/law/view/print?DocID=TXR%2FTR20163%2FNAT%2FATO%2F00001&PiT=99991231235958.

Taxation Determination on deductions for bad debts: trust beneficiaries and UPEs

On 14 December 2016 the ATO issued Taxation Determination TD 2016/19, which states that a trust beneficiary is not entitled to a deduction under s 25-35 of ITAA 1997 for an amount of unpaid present entitlement (UPE) that the beneficiary purports to write off as a bad debt. The Determination says this is because the amount of UPE is not included in the beneficiary's assessable income, but rather the entitlement is used to determine the amount of net income of the trust included in the beneficiary's assessable income under Div 6 of Pt III of ITAA 1936.

Consequently, according to the Determination, the requirement in s 25-35(1)(a) of ITAA 1997 that the relevant debt must be included in the taxpayer's income in that year or an earlier income year cannot be met. Two examples are given, outlining one situation where there is a simple unpaid entitlement and one where an entitlement is treated as a loan.

The Determination was previously released as Draft Tax Determination TD 2015/D5.

Date of effect

Taxation Determination TD 2016/19 applies to years of income commencing both before and after its date issue (14 December 2016).

Source: ATO, Taxation Determination TD 2016/9 Income tax: is a beneficiary of a trust entitled to a deduction under section 25-35 of the Income Tax Assessment Act 1997 for the amount of an unpaid present entitlement to trust income that the beneficiary has purported to write off as a bad debt? http://law.ato.gov.au/atolaw/view.htm?docid=%22TXD%2FTD201619%2FNAT%2FATO%2F00001%22

Taxpayers failed to prove that payments were "loans"

In a majority decision, the Full Federal Court has allowed the Commissioner's appeal and found that it was not open to the judge at first instance to find that payments of around $4 million made from a foreign company to its Australian subsidiary and other related companies were genuine loans (and not "shams"). In particular, the Court majority found it was not appropriate to find that the taxpayers had discharged the onus of proving that assessments were excessive in circumstances where the taxpayers had made inconsistent (or "alternative") arguments about the nature of the payments.

Background

The case involved assessments and amended assessments issued to several taxpayer companies covering the 1994 to 2009 income years. In these assessments, the Commissioner claimed that payments from several overseas companies (Normandy Finance and Investments Asia Ltd, Normandy Finance and Investments Limited and Hua Wang Bank Berhad) to the taxpayers were not loans, but sham transactions. Mr Henry George Townsing was the directing mind and will of each of these taxpayer companies, and the "lender" companies were owned by a company controlled by Mr Vanda Gould.

The Commissioner assessed the taxpayers on the basis that the payments were shams and that the amounts were ordinary income of the taxpayers and assessable under s 6-5 of the ITAA 1997. Normandy Finance claimed that some $3.8 million it received from Normandy Asia was by way of loans or financing.

At first instance, in *Normandy Finance Pty Ltd v FCT* [2015] FCA 1420, the Federal Court held that the payments were genuine loans, and not shams. It did so on the basis of finding that while the written agreements were shams or largely shams, they were only implemented for the limited purpose of making third parties believe that the borrowers were at arm's length from the lenders. However, otherwise, the Court at first instance found that the advance and repayment obligations (whether in the loan agreements or from some oral agreement) were "genuine".

On appeal, the Commissioner argued that it was not open to the primary judge to make this finding, as it was contrary to the case the taxpayers had put for the purpose of discharging their onus of proving that the assessments were excessive. In particular, the Commissioner claimed that the Court at first instance could not find that the payments were "loans" when the taxpayers had inconsistently argued that, on one hand, the loans were "wholly genuine" while, on the other (in their "alternative" argument), the loans involved at least some pretence for the limited purpose of making third parties believe that the borrowers were at arm's length from the lenders.

Note that following the decision of the Court at first instance, Edmonds J, sitting as a Presidential Member of the AAT, also ordered that a number of the assessments of income tax and penalty tax issued to the relevant parties should be accordingly reduced.

Decision

The Full Federal Court majority agreed with the Commissioner that it was not open to the Court at first instance to make the finding that the loans were genuine, as it was "impermissible for the primary judge to determine the case on a basis inconsistent" with the manner in which the taxpayers had argued the matter – namely, that on one hand the loans were genuine but, on the other hand, they were shams for a different purpose (ie for the purposes of their "alternative" case).

In short, the majority found that arguing the case in this manner "necessarily meant that only one outcome was open – the taxpayers had not discharged their onus of proof that the assessments were excessive because they had not proved the moneys advanced were loans".

Specifically, the majority considered the conclusion of the Court at first instance was "not only inconsistent with the evidence of the directing mind and will of the borrowers, but was incapable of any form of rational reconciliation with that evidence". Furthermore, the majority said it was a conclusion "made in circumstances where all of the lenders had been cross-examined on the basis of a different case before the alternative case was first raised by the primary judge (which may not be fatal of itself, given that their evidence was of marginal significance), but also where the evidence of the key witness, Mr Townsing, precluded any possibility of the credibility of the alternative case being explored in cross-examination (which is fatal in and of itself, given that Mr Townsing was the directing mind and will of the taxpayers)".

Logan J, in dissent, was of the view there was no basis for disturbing the conclusions reached by the Court at first instance, and at the same time rejected the Commissioner's contention that the primary judge delivered inadequate reasons.

However, in relation to dealings between Normandy Asia and Normandy Australia involving loans, the majority accepted that it would have been open to the primary judge, on the case which the taxpayers ran, to conclude that the taxpayers had discharged their burden of proof with respect to the dealings between Normandy Asia and Normandy Australia involving loans. The majority considered that this aspect of the appeal "must be remitted for further hearing and cannot be dealt with as part of the appeal".

FCT v Normandy Finance and Investments Asia Pty Ltd [2016] FCAFC 180, Full Federal Court, Logan, Jagot and Davies JJ, 16 December 2016, http://www.austlii.edu.au/au/cases/cth/FCAFC/2016/180.html.

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